85-855

No.____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

ARKLA, INC.,

Petitioner,

V.

UNITED STATES OF AMERICA,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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PETITION FOR WRIT OF CERTIORARI

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November 18, 1985

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QUESTIONS PRESENTED FOR REVIEW

1. The underlying and crucial issue which this case presents for review and decision, is what constitutes *the property* used in the trade or business of a taxpayer as the term "property" is used in Section 48(a)(1) of the Internal Revenue Code of 1954, as amended (herein the "Code").

2. Secondarily, and somewhat as sub-issues which should be resolved upon determination of that principal issue, this case presents the following specific questions for ultimate resolution of the case:

   A. Is a gas storage facility in its entirety (with the exception of buildings and their structural components) property for which investment tax credit (herein sometimes referred to as "ITC") is to be allowed?

   B. Is cushion gas, including both the recoverable and nonrecoverable portions thereof, a part of such a gas storage facility such that it is a part of a facility for which ITC is to be allowed?

   C. Did the Court of Appeals err when it treated the recoverable portion of the cushion gas as a separate and distinct part of the gas storage facility and held that such part did not satisfy the requirements for entitlement to ITC?

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PETITION FOR WRIT OF CERTIORARI

TO THE HONORABLE, THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

ARKLA, INC., the petitioner herein, prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit, entered in this cause on July 15, 1985, reversing the decision of the United States District Court, Western District of Louisiana and remanding the case to that Court for entry of judgment in favor of the United States.

OPINIONS BELOW

In the proceedings before the Trial Court, Arkla (sometimes herein the "Taxpayer") and the Government filed cross-motions for summary judgment. On August 6, 1984, the Trial Judge, the Honorable Tom Stagg, entered an order granting the Taxpayer's motion for summary judgment and denying the Government's, and on that same date the Trial Court issued its Memorandum Ruling with respect thereto (*Arkla, Inc. v. U.S.*, 592 F. Supp. 502 (W.D. La. 1984); Appendix C, *infra*, p. 9a). The Trial Court granted judgment in favor of the Taxpayer and against the United States in the stipulated amount of $1,129,746.37 as a refund of 1980 Federal income taxes, together with legal interest thereon (Appendix D, *infra*, p. 30a).

The Government filed its appeal to the United States Court of Appeals for the Fifth Circuit, and on July 15, 1985, the opinion of that court was issued reversing the decision of the Trial Court and remanding the case for entry of judgment in favor of the United States (*Arkla, Inc. v. U.S.*, 765 F.2d 487 (5th Cir. 1985); Appendix A, *infra*, p. 1a). The Taxpayer's timely filed application for rehearing was denied by the Court of Appeals on August 20, 1985 (*Arkla, Inc. v. U.S.*, 772 F.2d 904 (5th Cir. 1985); Appendix B, *infra*, p. 8a) and formal judgment was entered by the Trial Court on September 10, 1985 (Appendix E, *infra*, p. 31a).

JURISDICTION

The judgment of the Court of Appeals entered on July 15, 1985 (Appendix A, *infra*, p. 1a) has decided an important question of federal law, the availability of investment tax credit under 26 USCA § 38, which necessarily requires interpretation and application of the provisions of 26 USCA § 48 for a gas storage facility which is described in 26 USCA § 48(a)(1)(B)(iii). Taxpayer's timely filed application for re-

hearing was denied on August 20, 1985 (Appendix B, *infra*, p. 8a). Thus, pursuant to 28 USCA § 1254(1), jurisdiction to review the judgment of the Court of Appeals for the Fifth Circuit by writ of certiorari is conferred upon this Court.

STATUTES INVOLVED

The statutes involved for resolution of this case are Code § § 38, 48(a), and 167(a) (attached in Appendices F, G and H, *infra*, at pp. 32a, 33a, and 35a, respectively) and Treasury Regulation § § 1.48-1(a), 1.48-1(b) and 1.167(a)-2 (attached in Appendices I and J, *infra*, pp. 36a and 38a).

STATEMENT OF THE CASE

A. Summary of Proceedings and Holdings Below.

This proceeding is a suit by Taxpayer for refund of United States corporate income taxes for the calendar year 1980 and was initiated pursuant to 28 USCA § 1346(a). The suit by Taxpayer asserts that it is entitled to investment tax credit, pursuant to Code § 48(a)(1)(B), on the costs associated with the construction of a gas storage facility, including particularly the cost of all "cushion gas" therein, both that portion of the cushion gas which may be "recoverable" and that portion which may be "nonrecoverable." The Internal Revenue Service allowed Taxpayer ITC on all of its claimed costs associated with the construction of the storage facility with the exception of the cost of that portion of the cushion gas which was deemed recoverable. This proceeding thus concerns Taxpayer's entitlement to a refund of its 1980 corporate income taxes based on whether it is entitled to ITC with respect to the value of the recoverable portion of the cushion gas in that gas storage facility.

Basically, and succinctly, the Trial Court found that "the property" at issue for consideration of its qualification for investment tax credit was the entirety of the cushion gas—

both the recoverable and nonrecoverable portions thereof, and that such quantity of cushion gas was depreciable property with an estimated useful life of more than 7 years and thus satisfied the requirements of Code § 48 as property for which ITC was allowable. It followed and applied the rules applicable to line pack gas (acknowledged by both parties to be functionally identical to cushion gas) as determined by the Court of Claims in *Transwestern Pipeline Company v. U.S.*, 639 F.2d 679 (Ct. Claims 1980).

The Court of Appeals for the Fifth Circuit, however, considered the recoverable portion of the cushion gas (only the recoverable portion of the cushion gas and not the entire amount of the cushion gas) as a separate and distinct part of the facility and found that the recoverable portion of the cushion gas, when so considered, did not have a finite useful life and that taxpayer would not suffer any economic loss as to that part of the cushion gas. Thus, it found that the recoverable portion of the cushion gas, when considered as a separate and distinct property, was not property for which depreciation is allowable and thus did not qualify for ITC.

The decision of the Fifth Circuit in these proceedings is in conflict with the rationale and holding of the Court of Claims in *Transwestern* as applied to the functionally identical property, line pack gas in a natural gas pipeline. In addition, its holding is in direct conflict with two other Court of Claims decisions and one decision by the Federal Circuit interpreting the investment tax credit provisions. Furthermore, it did not follow the various decisions of this Court in its application of the principles of salvage value in the context of depreciation and obsolescence.

B. Pertinent Facts.

In the late 1970's Arkla, to permit it to continue service to its customers who were then having their service curtailed

during the coldest part of the winter, sought an appropriate gas reservoir to be constructed into a gas storage facility. Its lengthy search produced the Chiles Dome gas reservoir near Ardmore, Oklahoma and Arkla undertook the design and construction of a gas storage facility—a project with a total cost of approximately $50,000,000. One item absolutely essential and required for the operation of the gas storage facility is "cushion gas." This cushion gas was unquestionably the largest single cost component of the entire gas storage facility and, upon completion of the project, had cost the Taxpayer some $18,000,000 of the total $50,000,000 investment in that facility.

The stipulated facts in this proceeding contain a well documented recitation of Arkla's search for and selection of a suitable gas storage reservoir. Arkla selected the Chiles Dome reservoir and since it held absolutely no rights in that reservoir, the gas therein, or the surface above, it had to acquire all of the necessary rights and properties for the construction of the storage facility. It initially undertook the acquisition and construction of that storage facility through the purchase of storage rights and the acquisition, in fee ownership, of the necessary acreage for the construction of its surface compressors. It prepared exhaustive applications with the Federal Energy Regulatory Commission (herein the "FERC") and with the Oklahoma Corporation Commission (acting as that state's oil and gas commission) and ultimately secured approval from both the FERC and the Oklahoma Corporation Commission for the construction of the Chiles Dome gas storage facility. The filings with the FERC and Oklahoma Corporation Commission show that the Chiles Dome gas storage facility was to consist of:

> (1) 20 injection/withdrawal wells (15 new wells to be drilled and 5 existing wells to be reworked) and 1 observation well;

(2) a 6,750 horsepower compressor station (4,500 horsepower on line and another 2,250 horsepower for backup);

(3) a central point facility to perform measurement, pressure regulation, dehydration, liquid separation and other similar functions;

(4) approximately 6.38 miles of 6 inch to 12 inch gathering lines to connect the wells to the compressor station;

(5) approximately 11.14 miles of 16 inch pipeline to connect the compressor station to Arkla's existing transmission Line "AD"; and,

(6) *14 billion cubic feet of cushion gas.*

The record unequivocally reflects that the useful life of the Chiles Dome gas storage facility was approximately 50 years. The parties stipulated that both recoverable and nonrecoverable portions of the cushion gas serve precisely the same function in a gas storage facility and the record also reflects that cushion gas in an underground storage facility and "line pack" gas in a gas pipeline are functionally identical.

REASONS FOR GRANTING WRIT

A. Summary of Reasons.

This Court should grant a writ of certiorari to consider and hear this case because:

(1) The decision of the Fifth Circuit in this case is in conflict with the decision of the Court of Claims in *Transwestern Pipeline Company v. U.S.*, 639 F.2d 679 (Ct. Claims 1980), as to its holding regarding the property for which depreciation is allowable and *Pacific Far East Line, Inc. v. U.S.*, 544 F.2d 478 (Ct. Claims 1976), *Oglebay Norton Co. v. U.S.*, 610 F.2d 715 (Ct. Claims 1979), and *Hawaiian Inde-*

pendent Refinery v. U.S., 697 F.2d 1063 (Fed. Cir. 1983), as to the application of the rules regarding entitlement to investment tax credit as to a portion of a particular asset.

(2) This Court has never specifically addressed the issue of what constitutes "the property" for purpose of ITC and depreciation and that concept is a critical issue in this case and under infinite other situations.

(3) The decision of the Fifth Circuit has a direct impact upon many taxpayers, yet it leaves a very important issue unresolved for those particular taxpayers—including many which own or operate gas storage facilities where cushion gas is an integral part of the facility and many others which own and operate gas pipelines, such as the Alaskan Pipeline, where line pack gas is a necessary element. The only guidance set by the Fifth Circuit for these taxpayers is that if "most" of the line pack gas or cushion gas is recoverable, no investment tax credit or depreciation deduction is allowable, but if the "vast majority" of the line pack gas or cushion gas is nonrecoverable then it is subject to depreciation and ITC.

B. The Decision of the Fifth Circuit is in Conflict with Decisions of the Court of Claims, the Federal Circuit and this Court.

The Court of Appeal's erroneous decision in this matter was undoubtedly, at least in part, the result of its focus on one particular "tree" rather than on the "forest." Placed in the vernacular of this case, it looked solely at the recoverable portion of the cushion gas and not at the gas storage facility which is itself the tangible property subject to the Congressionally granted investment tax credit. Nowhere in the statutory provisions for the investment tax credit, the legislative history which set forth the Congressional intent in adopting the original investment tax credit provisions or

any subsequent amendments thereto, or in any of the Treasury Regulations promulgated thereunder, is there even the slightest indication that a taxpayer is required to reduce its cost of acquiring an asset described in the ITC provisions by any amount of expected salvage prior to determining the amount of credit to which it is entitled. This, however, is precisely what the Government was in effect arguing in the case below and in which the Court of Appeals concurred by adopting its "tree" versus "forest" approach. This decision of the Fifth Circuit Court of Appeals puts it directly at odds with several decisions of the United States Court of Claims and the United States Court of Appeals for the Federal Circuit on the scope of the ITC entitlement and in conflict with this Court and the Court of Claims on the concept of salvage as it pertains to depreciation and obsolescence deductions.

Although the United States Court of Claims has now been reconstituted as the United States Claims Court and its decisions are now subject to review by the Court of Appeals for the Federal Circuit, all decisions rendered by the United States Court of Claims prior to September 30, 1982 were adopted as binding precedent by the Federal Circuit.[1] Accordingly, Court of Claims decisions rendered prior to September 30, 1982 continue to hold the status of Circuit Court decisions for determining the existence of a conflict among the Circuit Courts of Appeals under Rule 17 of this Court.

(1) Conflicting Investment Tax Credit Decisions.

The Fifth Circuit's decision was predicated on the last sentence of Code § 48(a)(1), which is applicable to all subparagraphs thereof and which provided in 1980:

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[1]See *South Corporation v. United States*, 690 F.2d 1368 (Fed. Cir. 1982).

> "Such term [Section 38 property] includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of three years or more."

In construing said provision, the Fifth Circuit looked solely at the recoverable portion of the cushion gas, rather than the gas storage *facility* as a whole, which the taxpayer contends should be considered as the "Section 38 property," or at the entirety of the cushion gas, which the District Court determined to be the "Section 38 property," and the Fifth Circuit held that since the taxpayer would not suffer an economic loss with respect to the recoverable portion of the cushion gas, no depreciation is allowable with respect thereto and the taxpayer is not entitled to ITC on the cost thereof. This decision is squarely at odds with decisions of the Court of Claims and the Federal Circuit in several respects.

In *Pacific Far East Line, Inc. v. United States*, 544 F.2d 478 (Ct. Claims 1976), the Court of Claims clearly held that the total cost of a facility was to be included in the basis for determining the investment credit without regard to the fact that all or a portion of such cost may not be includable in basis for depreciation purposes. The facilities at issue in *Pacific Far East* were two ships constructed by the taxpayer and partially paid for with funds withdrawn from certain "tax-deferred" reserve funds established pursuant to § 607 of the Merchant Marine Act of 1936 (46 USCA § 1177). The Commissioner disallowed investment tax credit on that portion of the cost of the two ships which was attributable to the amounts withdrawn from the "tax-deferred" reserve funds. The Commissioner argued in the Court of Claims that, to the extent the ships were acquired with the "tax-deferred" reserve funds, they were not "Section 38 property" because

depreciation was not allowable with respect thereto. The Commissioner's argument was premised on the fact that, in establishing the "tax-deferred" reserve funds, the taxpayer had entered into a closing agreement with the Commissioner in which the taxpayer agreed that funds derived from the "tax-deferred" reserves would not be utilized in determining the cost basis, and, since depreciation is allowed only with respect to such basis, no portion of the ships acquired with the "tax-deferred" reserves was subject to an allowance for depreciation.

In holding for the taxpayer in *Pacific Far East*, the Court of Claims made a number of holdings which are contrary to and in conflict with the Fifth Circuit in the present case.[2] Perhaps the most important and basic of the holdings reached by the Court of Claims was its recognition of the Congressional intent behind the investment tax credit provisions, which holding is in sharp contrast to the determination in that regard reached by the Fifth Circuit. The Court of Claims specifically found, after citing the legislative history of the investment tax credit provisions, that the major purpose thereof was to *reduce the cost* of new equipment. See, 544 F.2d at 483-84. The Fifth Circuit on the other hand in the case at issue equated the purpose of the investment tax credit with the depreciation deduction and held that they were both "designed *to compensate* a taxpayer *for actual economic loss.*" Emphasis supplied, see 765 F.2d at 490; Appendix A, *infra*, p. 1a, at p. 6a. A review of

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[2]In reaching its determinations, the Court of Claims held that the investment tax credit provisions were to be liberally construed, citing its previous decision in *Lykes Bros. Steamship Co. v. U.S.*, 513 F.2d 1342 (Ct. Claims 1975), and in accordance with the intent of Congress, citing this Court's decision in *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 79 L.Ed. 211, 55 S.Ct. 50 (1934). See 544 F.2d at 484.

the legislative history cited by the Court of Claims makes it imminently apparent that the Court of Claims was correct in its holding that the purpose of the ITC provisions was to reduce the cost of acquiring new facilities rather than to compensate for any anticipated loss with regard to same.

Further, the Court of Claims in *Pacific Far East* makes it abundantly clear that the "Section 38" credit was to be computed on the total cost of the property, undiminished by any adjustments to that cost basis for purposes of the depreciation deduction, which would include adjustments for salvage value. See, 544 F.2d at 484-85. The Commissioner had argued that Treas. Reg. § 1.48-1(b)(2) provides the authority for limiting the ITC allowance to that "part" of "Section 38 property" for which a depreciation deduction is "allowable." The Court of Claims cited the proffered regulation verbatim and found that the limitation to that "part" of the property set forth in the regulation was only intended to limit the ITC basis to business versus personal usage of certain assets and to restrict ITC where depreciation of certain assets was disallowed under Code § 274 (relating to disallowance of certain entertainment, etc., expenses). See, 544 F.2d at 486-87. In contrast to such Court of Claims holding, the Fifth Circuit did not review the regulations under the ITC provisions, but rather, presumably because of its fundamental error as to the Congressional purpose of the ITC provisions, chose to focus on and premise its decision upon the depreciation regulations under Code § 167. There the Fifth Circuit found solace in that portion of Treas. Reg. § 1.167(a)-2 (Appendix J, *infra*, p. 38a) which provides that a taxpayer is entitled to a depreciation allowance only with respect to "*that part* of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence." (Emphasis supplied by the court, 765 F.2d 487, 490; Appendix A, *infra*, p. 1a, at p. 6a.)

While the Court of Claims was concerned in *Pacific Far East* with the "source" of the funds making up the cost basis of the facility rather than the individual items of the facility making up such cost basis, the principle announced by the Court of Claims, that the term "part" referred to only the segregation of business and personal usage and to Code § 274 items, has equal applicability to the components of the facility. Accordingly, the Court of Claims finding, which is in accordance with Congressional intent, is contrary to the result reached by the Fifth Circuit in the instant case. Undoubtedly, the facilities (the ships) under consideration in *Pacific Far East* also were composed of one or more individual items of property, such as ball-bearings or brass instrumentation, which, when salvaged at the end of the useful life of the ships, would bring a price that was equal to or greater than the initial cost of such individual components. There is no doubt, if such had been specifically at issue, the Court of Claims would have arrived at the same conclusion with regard to the "part" limitation of Treas. Reg. § 1.48-1(b)(2) as it did regarding the source of the funds.

While Code §§ 38 and 167, particularly the liberalized depreciation provisions of § 167 (now the ACRS provisions of Code § 168), have the common thread and Congressional purpose to stimulate investment in productive resources, the approach of the two provisions is entirely different. The approach, as the Court of Claims found, under Code § 38 is to encourage investment by reduction of the cost of new assets, while the approach of Code § 167, as this Court has found, is to permit a ratable return on the investment so that at the end of the useful life of the asset in the taxpayer's business it would have recovered, when salvage value is added thereto, its initial investment in the asset.[3] Accord-

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[3] *Massey Motors, Inc. v. United States*, 364 U.S. 92, 4 L.Ed.2d 1592, 80 S.Ct. 1411 (1960).

ingly, the Fifth Circuit's utilization of the Code § 167 concepts and regulations is entirely misplaced for Section 38 purposes and has resulted in a clear conflict with the Court of Claims' interpretation of the ITC provisions.

The subsequent decision of the Court of Claims in *Oglebay Norton Co. v. United States*, 610 F.2d 715 (Ct. Claims 1979), makes this conflict even clearer. In *Oglebay Norton* the facts were essentially the same as in *Pacific Far East* with the exception that in 1970 Congress had amended the Merchant Marine Act, as pertinent here, to provide for a consolidation of the previous "tax-deferred" reserve funds into one "tax-deferred" fund and to legislatively provide for a reduction in the tax basis of any vessel constructed or reconstructed with funds withdrawn from the "tax-deferred" fund (46 USCA § 1177 (1970)). Further, in *Oglebay Norton*, the entire cost of refurbishing the three vessels at issue therein had been withdrawn from the ordinary income portion of the "tax-deferred" fund which required a reduction of the tax basis of the vessels to zero under the Merchant Marine Act as amended. In arguing that the taxpayer was not entitled to the refunds therein sought, the Commissioner argued that "the improvements were not 'section 38 property' because, no depreciation being *allowed*, by implication none therefore was '*allowable*,' as required by the statutory definition, and, more specifically, none was 'allowable to the taxpayer for the taxable year'"[4] citing Treas. Reg. § 1.48-1(b)(1). Further, the Government contended "that even if the improvements could be considered 'section 38 property' *in toto*, 'the basis'"[5] as required to be reduced by the Merchant Marine Act becomes zero. Thus, "the 'qualified investment' referred to in section 46 of the code also becomes zero, and that 7% [the then applicable ITC

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[4] 610 F.2d 715, 720 (Emphasis supplied).

[5] *Id.*

percentage] of zero is zero.'"[6] Again, in finding for the taxpayer, the Court of Claims set forth the same reasoning it utilized in *Pacific Far East*, *supra*, to which it cited and from which it quoted extensively. More significantly to the instant case, it expanded its opinion to hold that the adjustment to basis "does not convert the property from 'property with respect to which depreciation is allowable' to 'property with respect to which depreciation is *not* allowable'; it merely affects the amount of the deduction that Congress will permit taxpayer to take for depreciation of 'property with respect to which depreciation is allowable.'"[7] (Emphasis supplied by the court)

Again, the contrary result reached by the Fifth Circuit in the instant case is the result of its looking at the "tree" rather than the "forest." The Fifth Circuit ignores the gas storage "facility" which is specifically defined in Code § 48(a)(1)(B)(iii) as the "Section 38 property" and the total volume of cushion gas which was viewed by the Trial Court as the "Section 38 property," and focuses only on the recoverable portion of the cushion gas which it determined is not "Section 38 property" because it will be recoverable in its elemental state at the end of the useful life of the facility. If the Fifth Circuit had followed the logical conclusions of the Court of Claims in *Oglebay Norton*, it would have had to conclude that the salvage value of the facility consisted of the value of the recoverable portion of the cushion gas together with the scrap value of the pipes and compressors and that such salvage value merely limited the *amount* of depreciation the taxpayer was allowed to take on the facility which is property with respect to which depreciation is allowable. To follow the Court of Claims' reasoning further, if the whole

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[6] *Id.*

[7] *Id.* at 724.

cost of the facility could have been recovered at the end of its useful life because of the high salvage value of its components, it would have still necessarily held that the facility was "Section 38 property" as it was property "with respect to which depreciation was allowable" despite the fact that the salvage factor in the "depreciation equation" would have reduced the depreciable basis to zero so as to not permit the taxpayer any depreciation deduction. This Court has specifically recognized that salvage is part of the "depreciation equation" which limits the amount of the depreciation deduction to which a taxpayer may be entitled to claim and, even though that salvage value may represent a high percentage of the original cost of an asset, such salvage value does not convert the asset into property for which depreciation is not allowable.[8]

Whether the focus is to be on the facility itself or on its components, even considering the recoverable portion of the cushion gas as a separate component, the decision of the Fifth Circuit in this case is in conflict with the Court of Claims in *Oglebay Norton*. As the Fifth Circuit itself noted in its opinion, the distinction between "recoverable" and "nonrecoverable" portions of the cushion gas is purely an accounting categorization based on estimates of what will be commercially removable and marketable at the end of the facility's useful life.[9] Clearly then, it is inconceivable how the portion which the accountants have estimated to be "nonrecoverable" can take the characterization of property for which depreciation is "allowable" while that portion determined to be "recoverable" is property for which de-

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[8]See, *e.g. The Hertz Corporation v. United States*, 364 U.S. 122, 4 L.Ed.2d 1603, 80 S.Ct. 1420 (1960) and *Massey Motors, Inc. v. United States*, *supra* note 3 at p. 12.

[9]*Arkla, Inc. v. U.S.*, 765 F.2d 487, 488; Appendix A, *infra*, p. 1a at 2a-3a.

preciation is *not* "allowable." This accounting classification distinction does not change the nature of the asset any more than the source of the funds changed the nature of the asset in *Oglebay Norton* wherein the Court of Claims stated:

> "If taxpayer had used solely its own money, there would be no question that it would be entitled to a depreciation deduction. *Simply because a depreciation deduction was not allowable in this instance does not mean the improvements were not depreciable property within the meaning of Section 38.*" (Emphasis supplied, 610 F.2d 715, 725.)

If the taxpayer's accountants in this instance had looked into their crystal ball fifty years into the future with the assistance of taxpayer's engineers and determined, based on projected technologies and projected economics, that *no portion* of the cushion gas would be recoverable, then this taxpayer would not be before this Court any more than the taxpayer would have been before the Court of Claims in *Oglebay Norton* had it used funds from sources other than the "tax-deferred" reserves to pay for its facilities.

There is no difference in the cases—whether the asset has a zero basis on the front end for depreciation purposes because the source of the funds were not part of the cost basis, or a zero basis on the back end because of the effect of the salvage value deduction in the "depreciation equation," the result is the same. It does not change the nature of the property intended by Congress to qualify for the Section 38 credit for the intended purpose of encouraging investment in facilities such as ships and storage facilities utilized in conjunction with the furnishing of gas services by lowering the cost of investing in such facilities.

The Fifth Circuit's approach of viewing the "tree" rather than the "forest" is also in conflict with a decision of the

Federal Circuit in which that Court upheld the Government's position that the "Section 38 property" is the facility as a whole and *not* the component parts thereof. In *Hawaiian Independent Refinery v. U.S.*, 697 F.2d 1063 (Fed. Cir. 1983), at issue was the availability of the investment tax credit with respect to an oil refinery complex which was in the process of construction when the investment tax credit was restored by Congress in 1971, after having been terminated in 1969. The Section 38 credit was restored by Code § 50 which contained certain effective dates that basically provided ITC would be available in full for constructed property, only if the construction was begun after March 31, 1971 and completed after August 15, 1971, and would be available for acquired property, only if acquired by a taxpayer subsequent to August 15, 1971. Code § 50 also contained a transitional rule which allowed a taxpayer to claim ITC only on that portion of its basis attributable to construction after August 15, 1971 where construction had begun prior to April 1, 1971. The taxpayer in *Hawaiian Independent* had begun construction of the oil refinery complex in January of 1971 and same was placed in service in June, 1972. The taxpayer claimed ITC on the whole refinery complex which consisted of three major cost elements, the refinery itself, a marine terminal, and a products pipeline. The Commissioner disallowed the claimed ITC on all construction costs incurred by the taxpayer prior to August 15, 1971 under the Code § 50 transitional rule based on a determination that construction had commenced prior to April 1, 1971. The taxpayer's primary argument was that it had "acquired" the property under a turnkey construction contract after August 15, 1971 rather than having "constructed" same, and accordingly, the transitional rule was not applicable. After finding as a matter of fact that the taxpayer had "constructed" the complex and rejected the taxpayer's primary argument, the Federal Circuit consid-

ered the taxpayer's alternative argument which is of extreme importance here.

In *Hawaiian Independent* the taxpayer argued, alternatively, that the full cost of the two off-site components, the marine terminal and the products pipeline, should be considered as separate properties from the refinery and ITC allowed on the full cost thereof because construction work on them did not begin until after April 1, 1971, thus making the transitional rule inapplicable. The Federal Circuit, in rejecting the taxpayer's argument, specifically noted and approved the trial judge's determination of what constitutes "the property," holding that all the components including the two off-site components, in conjunction with the refinery itself, "*functionally form a single property*"[10] for ITC purposes. It is interesting to note the Government's response to the taxpayer's alternative argument was "that if the tanker-mooring facility and the refined products pipelines are considered separate projects, and, thus, 'separate properties' for purposes of Code § 50, they would not qualify as 'Section 38 property' under Code § 48(a)(1)(B), IRC."[11] The Federal Circuit stated it was not necessary for it to consider that argument by the Government, since it determined that the entire refinery complex was "the property." However, it does point to the fact that Code § 48(a)(1)(B) contains a special definition of "Section 38 property" which is intended to encompass property which ordinarily would not be considered "Section 38 property" but for the fact such property is a "part" of the activities or facilities described in Code § 48(a)(1)(B), which provision only excludes buildings and their structural components.

The conflict between the Fifth Circuit in this case and the Federal Circuit in *Hawaiian Independent* is clear. The

[10]697 F.2d 1063, 1069.

[11]*Id.* at note 12.

Federal Circuit held that the "Section 38 property" is the entirety of a functionally coherent facility, not its individual component parts, and certainly not the further subdivision of those individual component parts between what is salvageable and salable and that which is not. On the other hand, the Fifth Circuit's decision has not only rejected the "forest" (the gas storage facility) as the "Section 38 property," its decision has in effect found only the branches and leaves of the tree (the nonrecoverable portion of the cushion gas) "Section 38 property," since they presumably have no salvage value, but the trunk (the recoverable portion of the cushion gas) is not "Section 38 property" because it can be cut and sold as timber.

(2) Conflicting Depreciation Decisions.

Even if one were to accept the Fifth Circuit's engrafting of the Code § 167 regulations onto the ITC provisions for the purpose of determining what is "Section 38 property," its decision ignores and is in conflict with several important concepts of depreciation/obsolescence enunciated by this Court. One of those conflicts, which was maintained above, arises from the Fifth Circuit's failure to recognize that salvage value is simply a part of the "depreciation equation."[12] The basic conflict, however, arises from the Fifth Circuit's failure to recognize that what is *recoverable* only establishes the salvage value which is then utilized in determining the proper deduction for depreciation/obsolescence. This Court early recognized and enunciated this concept in *Burnett v. Niagra Falls Brewing Company*, 282 U.S. 648, 75 L.Ed. 594, 51 S.Ct. 262 (1931), wherein it was stated:

> "In determing the proper deduction for obsolescence there is to be taken into consideration *the amount*

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[12]*The Hertz Corporation v. United States* and *Massey Motors Company, Inc. v. United States*, *supra* note 8 at p. 15.

> *probably recoverable, at the end of its service, by putting the property to another use or by selling it as scrap or otherwise. There is no hard and fast rule,* as suggested by the Government, *that a taxpayer must show that his property will be scrapped or cease to be used or useful for any purpose before any allowance may be made for obsolescence.*" (Emphasis supplied, 282 U.S. 648, 655, 75 L.Ed. 594, 598)

In that same case, this Court also recognized that "obsolescence is not necessarily confined to particular elements or parts of a plant; the whole may become obsolete."[13] In another case the following year, this Court again recognized and restated its opinion that where the "whole becomes obsolete" what "remains" is to be regarded as salvage.[14]

What this Court recognized and held in *Burnett* and *Cartridge Company* has a direct application to the situation present in the instant case, as the Taxpayer has established as a matter of fact that its property (the gas storage facility) will become obsolete as a whole in approximately 50 years. Thus, the Fifth Circuit, by ignoring the salvage value in the equation, has, in effect, rejected and is in conflict with this Court's clear holdings in *Burnett* and *Cartridge Company*. As it was summarized by this Court in *Cartridge Company*:

> "Obsolescence may arise from changes in the art, shifting of business centers, loss of trade, inadequacy, supersession, prohibitory laws and other things which, apart from physical deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value. (Citations Omitted)

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[13]282 U.S. 648, 654, 75 L.Ed. 594, 597.

[14]*United States Cartridge Company v. United States*, 284 U.S. 511, 76 L.Ed. 431, 52 S.Ct. 243 (1932).

* * *

> "That remaining . . . was properly to be regarded as in the nature of salvage." 284 U.S. 511, 516-18, 76 L.Ed. 431, 435.

Another Court of Claims' decision which is in conflict with the present decision of the Fifth Circuit, is *Transwestern Pipeline Co. v. United States*, 639 F.2d 679 (Ct. Claims 1980). In that decision, the above enunciated concepts of obsolescence and salvage value were properly recognized in allowing depreciation of "line-pack" gas in a pipeline which the Court of Claims found to be functionally identical to "cushion gas" in a storage reservoir. While the Fifth Circuit considered *Transwestern* in reaching its decision in the present matter, it dismissed *Transwestern* as being factually distinguishable because the "vast majority" of the "line-pack" gas would be unrecoverable at the end of the useful life of the pipeline while most of the cushion gas will be recoverable at the end of the reservoir's useful life. This distinction by the Fifth Circuit is obviously without merit and, as the District Court below noted "flies in the face of common sense." See, 592 F. Supp. at 513; Appendix C, *infra*, p. 9a at p. 29a. As this Court has observed:

> "The failure to take into account salvage value prevents this [an accurate estimate of annual depreciation] since it will result in an understatement of income during the years the asset is employed and an overstatement in the year of disposition. The practice has therefore grown up of *subtracting salvage value* from the purchase price to determine the *depreciation base*."[15] (Emphasis supplied.)

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[15] *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104-5, 4 L.Ed.2d 1592, 1600.

The Taxpayer here before the Court did nothing more. It subtracted the salvage value, which was estimated to be the value of the recoverable portion of the cushion gas, from its total investment in the facility and depreciated same on the remainder of the *depreciation base*, and, although that base was reduced substantially because of the high salvage value estimated, just as the salvage value was high in *Massey*, it did not affect the fact that the property itself, the storage facility, was depreciable. In *Transwestern*, the Court of Claims found that between 3% and 20% of the volume of "line pack" was recoverable and that the value thereof was the salvage value of the "line pack," but the whole of the "line pack" was property subject to an allowance for depreciation. In the instant case, at the time the facility was placed in service, it was estimated that approximately 95% of the volume of cushion gas would be economically recoverable (representing about 40% of the initial cost of the facility). However, based upon the decisions of this Court, the depreciability of an asset is not dependent upon the value or quantity of its salvage. Accordingly, there is a conflict between the decisions of the Fifth Circuit in this case and *Transwestern*, as well as a conflict with this Court's decisions cited above.

C. What Is "The Property"?

As the foregoing conflicts note, the underlying question is what constitutes "the property" for purpose of the provisions of Code § 48. In this particular case, there are at least four potential answers to that question:

(i) The Gas Storage Facility (excluding any buildings or their structural components), as the Federal Circuit held in *Hawaiian Independent*, *supra*, and as is advocated by the Taxpayer.

(ii) The Cushion Gas, including both the recoverable and nonrecoverable portions thereof, as determined by the Trial Court.

(iii) The Recoverable Cushion Gas, as advocated by the Government and as determined by the Fifth Circuit.

(iv) Each molecule of gas (not yet advocated by anyone).

Taxpayer notes that the decision of the Fifth Circuit, holding that the Government may segregate a part of the facility (in this case the recoverable portion of the cushion gas) for purposes of application of the rules for ITC, taken to its logical conclusion, authorizes the Internal Revenue Service (herein "the IRS") to review each and every discernible part of every property to find a "part" which can be shown to have a salvage value equal to or in excess of its original cost and thereby to deny ITC on the cost of that part.

A simple example reflects how illogical the Fifth Circuit's decision is. The lug nuts on an automobile can invariably be sold when the car is worn out for more than their original cost. The Fifth Circuit decision would authorize the IRS to prohibit ITC on the cost price of the lug nuts on the car. Many, many other examples can be cited and this Court should use this case to set the broad guidelines of what constitutes "the property" for purposes of Section 38. In the example, the car is obviously the property, not the wheels, motor block, pistons, doors, trim and lug nuts. In the case at issue, the property is the gas storage *facility*, just as Code § 48 contemplates, not the individual compressors, gathering lines, wells, pipe, and cushion gas—and certainly not the recoverable portion of the cushion gas.

A need for guidance to be followed in determining what is "the property" was recently highlighted again by the IRS itself when it cited a revenue ruling which held that a computer is a computer, as authority for holding that an oil well is not an oil well for ITC purposes. In Revenue Ruling 85-156, Internal Revenue Bulletin No. 1985-40, page 9, issued October 7, 1985, the IRS held that although the property placed on an oil well performs a unitary function, each well contains a number of separate items of "Section 38 property" which must each, independently, be categorized for purposes of Section 38. That Revenue Ruling cites as authority Revenue Ruling 80-313, 80-2 C.B. 25, which held that a computer, which was built with circuit boards (a major component) salvaged from obsolete computers, was the "Section 38 property" and implicitly found that the reconstructed circuit boards, admittedly salvaged from obsolete computers, were not separate items of "Section 38 property." It allowed ITC on the computer as new "Section 38 property," presumably including the cost of the reconditioned boards. Why were those computer boards not a separate item of "Section 38 property" as was the pipe in the latter ruling? The examples are endless, but the currentness of this obvious inconsistency in Revenue Rulings, one of which is only one month old, accentuates the importance of this issue.

Revenue Ruling 85-156 clearly recites that the components of the oil well under consideration perform a unitary function. That Revenue Ruling is totally inconsistent, however, with the extremely recent decision of the Federal Circuit in *Hawaiian Independent*, *supra*, where it found that components which "functionally form a single property" are one property for purposes of the ITC provisions. A decision of this Court to provide the general foundation for the rational determination of what constitutes "the property" for purposes of ITC is unquestionably necessary.

CONCLUSION

The investment tax credit is actually established in Code § 38 through the innocuous provisions, "There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under Subpart B of this part." Then in Subpart B, Code § § 46-48, the complex rules with respect to investment tax credit are set forth. The statutory provisions which are pertinent to this determination are set forth in Code § 48(a)(1), which provides in part:

> ". . . the term 'Section 38 property' [property for which investment tax credit is allowable] means—
>
> (A) tangible personal property (other than an air conditioning or heating unit), or
>
> (B) other tangible property (not including a building or its structural components) but only if *such property*—
>
> (i) is used as an integral part of manufacturing, production or extraction or of furnishing transportation, communications, electrical energy, gas, water or sewage disposal services, or
>
> (ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or
>
> (iii) constitutes a *facility* used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in liquid or gaseous state) . . ." (Emphasis supplied.)

The statutory provisions clearly contemplate that the gas storage *facility* is to be "the property" for which investment tax credit is allowable, however, the Government has con-

vinced the Fifth Circuit that the recoverable portion of the cushion gas is a separate and distinct property for application of that section. The parties stipulated that the cushion gas at issue is tangible property, is not a building or its structural component, and constitutes a part of the facility for the bulk storage of gas, which facility is itself used in connection with the furnishing of gas services. Thus, the parties have stipulated that the cushion gas is part of a facility which satisfies the definitional requirements of Code § 48(a)(1)(B)(iii). This statutory provision clearly suggests that the property to be considered for purposes of that section and eligibility for ITC, including the last sentence of that section, is *the facility*, not individual components of the facility. The Senate report on the Revenue Act of 1962, in the discussion of what it intended to qualify as "Section 38 property," provides:

> "Section 38 property (defined in sec. 48(a)), is the only property (either new or used) which is treated as 'qualified investment'. Except for the exclusions noted below, *all tangible property qualifies as section 38 property*. Except for buildings, and their structural components, *real property which is used as an integral part of* manufacturing, production or extraction or furnishing transportation, communication, electrical energy, *gas*, water or sewage disposal *services* also *qualifies as section 38 property. This is also true of real property* (other than buildings and structural components) *used for* research or *storage facilities* with respect to any of the above categories. Tangible personal property is not intended to be defined narrowly here, nor to necessarily follow the rules of State law. It is intended that assets accessory to a building such as grocery store counters, printing presses, individual air conditioning units, etc., even though fixtures under

> local law, are to qualify for the credit." (Emphasis supplied, Senate Report No. 1881, U.S. Code, Cong. & Adm. News, 87th Congress, 2nd Sess., page 3318)

Thus, it is clear that, from the outset, the investment tax credit was designed not for recoupment of economic losses, as the Fifth Circuit suggests, but rather to stimulate investment in certain properties—with gas storage facilities being statutorily included and specifically referenced in the committee reports. Arkla made an investment in just the type of asset Congress contemplated—it invested approximately $50,000,000 in a gas storage facility. That facility is statutorily recognized as the specific investment contemplated by Congress; it is real property used for storage facilities which is an integral part of furnishing gas services. The FERC approved that $50,000,000 investment, including the approximate $18,000,000 investment in cushion gas. This cushion gas is clearly classified by the FERC as a part of that fixed asset, the underground gas storage facility. The credit allowed under Code § 38 was not intended to amortize any potential economic loss from such investment, but rather was specifically designed to increase the rate of capital formation by reducing the net cost of the investment.

The decision of the Fifth Circuit conflicts with the decisions noted above of other circuits, both as to what constitutes "the property," the application of the pertinent regulations regarding "that part" of the property, and it does not apply this Court's rulings on the obsolescence of the facility as a whole, and the application and effect of salvage value. Therefore, this Court should grant a writ of certiorari to the Fifth Circuit to hear this case and

decide these important issues for all taxpayers.

Respectfully submitted,

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

July 15, 1985

No. 84-4642

ARKLA, INC.,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Integrated natural gas company brought action seeking federal income tax refund based on claimed increased investment tax credit for cost of recoverable "cushion gas" located in underground gas reservoir. The United States District Court for Western District of Louisiana, Tom Stagg, Chief Judge, 592 F.Supp. 502, granted summary judgment for gas company, and United States appealed. The Court of Appeals, Gee, Circuit Judge, held that the gas company's recoverable cushion gas was not subject to depreciation, and thus, gas company was not entitled to investment tax credit for the recoverable cushion gas.

Reversed and remanded.

Appeal from the United States District Court for the Western District of Louisiana.

Before GEE, TATE and HIGGINBOTHAM, Circuit Judges.

GEE, Circuit Judge:

Arkla, Inc. (Arkla) brought an action in the district court seeking a refund of federal income tax it paid for 1980. The district court granted summary judgment for Arkla. 592 F.Supp. 502. We reverse.

I.

Arkla is an integrated natural gas company providing natural gas to customers in Arkansas, Louisiana, Kansas, Oklahoma, and Texas. To provide for future gas storage needs, Arkla decided to convert a natural underground gas reservoir in eastern Oklahoma known as the "Chiles Dome" facility into a gas storage reservoir. To this end, Arkla acquired from the surface owners the right to store gas in the formation, as well as surface rights for drilling wells, laying pipelines, and constructing gathering and transmission facilities.

Arkla determined that in order to operate the reservoir at peak efficiency it would have to maintain a certain minimum gas pressure at the intake side of the compressors pumping gas out of the facility into the attached delivery lines. To achieve that pressure, Arkla maintains in the facility a volume of natural gas known as "cushion gas." Cushion gas is physically indistinguishable from the natural gas delivered to customers; the term simply refers to the volume of gas required to maintain the desired pressure in the reservoir. Arkla provided the requisite amount of cushion gas in the Chiles Dome reservoir by purchasing native gas already present there and by injecting additional gas purchased elsewhere.[1]

Arkla created two separate accounting categories for the natural gas it acquired. These categories were designed to distinguish between the "recoverable" cushion gas (i.e. that gas that will be commercially removable and marketable when

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[1]During 1980, the year Arkla put the Chiles Dome facility into service, Arkla purchased for $328,305.20 the 3,499,381 thousand cubic feet (MCF) of native gas already in the reservoir to be used as cushion gas. Arkla also purchased for $9,689,239.16 another 5,979,277 MCF of natural gas, which was injected into the reservoir as additional cushion gas.

the reservoir is no longer used as a storage facility) and the "nonrecoverable" cushion gas.[2]

On its original 1980 federal income tax return Arkla claimed an investment tax credit under § 38 of the Internal Revenue Code ("the Code") for the cost of the nonrecoverable cushion gas. The Internal Revenue Service (IRS) allowed a credit for $22,271.23. Arkla then filed an amended return for 1980 claiming an additional investment credit of $1,129,746.37 for the cost of the recoverable cushion gas. The IRS neither allowed nor disallowed this claim within six months after the amended return was filed, and Arkla brought an action in district court seeking a refund based on the claimed increased credit.

In the district court, the parties stipulated the factual questions, submitted the deposition testimony of two technical experts, and filed cross-motions for summary judgment. The sole issue was Arkla's eligibility for the investment tax credit with respect to the recoverable cushion gas. Resolution of this issue depended upon whether such gas constitutes depreciable property. After considering the issue, the district court filed a memorandum opinion ruling that the recoverable and nonrecoverable cushion gas was functionally identical and that the recoverable cushion gas was depreciable property. The court therefore granted Arkla's motion for summary judgment. The IRS appeals.

II.

(A) This case involves the application of several complex Code sections. Section 38 of the Code provides "there shall be allowed, as a credit against a tax imposed by this Chapter, the amount determined under Subpart B of this part." Subpart B includes Code §§ 46-48. The parties stipulated that cushion gas

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[2]Under the uniform system of accounts prescribed by the Federal Energy Regulatory Commission, Arkla placed the $193,662.91 cost of the 512,774 MCF of cushion gas it deemed "nonrecoverable" in one account, and the $9,823,881.45 cost of the recoverable cushion gas in another.

satisfies the requirements of Code § 48(a)(1)(B)(iii),[3] which classifies cushion gas as "Section 38 property," or property for which investment tax credit is allowed. In addition, the last sentence of § 48(a)(1) provides that "Section 38 property" includes only property with respect to which depreciation . . . is allowable and having a useful life . . . of 3 years or more. . . ." Thus, to qualify for the investment tax credit cushion gas must be a capital asset, depreciable, and have a useful life of over three years (seven years to receive the full tax credit). The district court ruled that Arkla's cushion gas satisfied these three requirements and entered summary judgment for Arkla on this basis.

(B) The district court's conclusions that the cushion gas is a capital asset and that the gas has a useful life of over seven years are clearly correct, and the IRS does not challenge them. The controversy in this case centers on the district court's ruling that both the nonrecoverable and the recoverable cushion gas is property "with respect to which depreciation . . . is allowable" within the meaning of Code § 48(a)(1).

In the portion of the district court's Memorandum Opinion that discusses whether the recoverable cushion gas is depreciable, the court first quotes Code § 167(a),[4] which provides guidelines for determining whether depreciation is allowable on a particular asset. The court then rejects the IRS's argument that the recoverable cushion gas is not an asset subject to

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[3]Code § 48(a)(1)(B)(iii) provides that the term "Section 38 property" includes tangible property which "constitutes a facility used in connection with any of the activities referred to in clause (i) for bulk storage of fungible commodities (including commodities in a liquid or gaseous state). . . ." Activities referred to in clause (i) (Code § 48(a)(1)(B)(iii)) include "manufacturing, production, or extraction, or . . . furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services. . . ."

[4]Code § 167(a) provides: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income."

exhaustion or wear and tear, and therefore not depreciable, stating:

> The fact stipulations in the Pretrial Order indicate that the government allowed an investment tax credit for *non-recoverable* cushion gas contained in the Chiles Dome facility. This allowance implies that the cushion gas, at least the non-recoverable component, is subject to depreciation. For the government to argue that natural gas, as a generic entity, is not subject to depreciation because it never wears out contradicts its allowance of an investment tax credit for the nonrecoverable cushion gas.

Memorandum Opinion, Record on Appeal at 177. The IRS contends that the district court erred in ruling that, because the recoverable and the nonrecoverable cushion gas are physically indistinguishable, no distinction between them can properly be made in determining whether the recoverable gas, like the nonrecoverable gas, is a depreciable asset. Therefore, the IRS argues, the district court erred in allowing Arkla's claim for an investment tax credit based on the value of the recoverable cushion gas.

We agree with the IRS that the district court erred in ruling that the recoverable cushion gas is subject to depreciation and that Arkla is entitled to an investment tax credit. That recoverable and nonrecoverable cushion gas are physically identical does not require them to be treated identically for depreciation purposes. The IRS allowed the investment tax credit for the nonrecoverable cushion gas Arkla claimed on its original 1980 federal income tax return because this gas will be unavailable for any use after the useful life of the storage facility ends. In essence, the useful life of the nonrecoverable gas is measured by the useful life of the storage facility. By contrast, the recoverable cushion gas will remain physically unchanged in the storage facility for an indefinite period of time. At any time that the storage facility is closed, the recoverable gas, by definition, will be available for sale or other use, with its general utility and value undiminished in any

fashion. That the nonrecoverable cushion gas will become obsolete along with the storage facility, while the recoverable cushion gas will not, mandates a different treatment of the two assets for depreciation purposes.

The IRS's position is supported by several other considerations as well. The depreciation deduction allowed by § 167 and the investment tax credit authorized by § 38 are designed to compensate a taxpayer for actual economic loss. While Arkla will clearly suffer economic loss with respect to the nonrecoverable cushion gas, the recoverable cushion gas, because it can be commercially removed from the storage facility at the end of the facility's useful life, does not represent a potential economic loss to Arkla. Furthermore, the Treasury Regulations interpreting § 167 provide that a taxpayer is entitled to a depreciation allowance only with respect to "*that part* of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence." Treas. Reg. § 1.167(a)-2 (emphasis added). This regulation's recognition that sometimes only part of a capital asset may be depreciable supports the IRS's distinction between recoverable and nonrecoverable cushion gas. Finally, a reading of § 48 suggests that for any cushion gas to qualify for an investment tax credit, the useful life of the gas must be measured by the useful life of the storage facility. Because only the nonrecoverable cushion gas can have a useful life measured in this way, Arkla is not entitled to an investment tax credit for the recoverable cushion gas.

The district court relied on *Transwestern Pipeline Co. v. United States*, 639 F.2d 679, 225 Ct.Cl., 399 (1980), to support its ruling in favor of Arkla, and Arkla relies on that case in this appeal. In *Transwestern*, the court held that "line-pack" gas, which performs the same function in pipelines as cushion gas does in reservoirs, was a capital asset depreciable over the useful life of the pipeline system. *Transwestern* is distinguishable from the instant case, however, because the "vast majority" of the line-pack gas involved there would be lost at the end of the pipeline's useful life. 639 F.2d at 681. In this case, most of

the cushion gas will be recoverable at the end of the reservoir's useful life. Because of this factual distinction, *Transwestern* cannot serve as authority for allowing Arkla's investment tax credit for the recoverable cushion gas.

For the foregoing reasons, the judgment of the district court is REVERSED, and the case is REMANDED for entry of judgment in favor of the United States.

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APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 84 4642

ARKLA, INC.,

Plaintiff-Appellee,

VERSUS

UNITED STATES OF AMERICA,

Defendant-Appellant.

Appeal from the United States District Court for the Western District of Louisiana

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ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion July 15, 5 Cir., 1985, _____ F.2d ____)

(AUGUST 20, 1985)

Before GEE, TATE and HIGGINBOTHAM, Circuit Judges.

PER CURIAM:

(✓) The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (Federal Rules of Appellate Procedure and Local Rule 35) the Suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

/s/ Thomas Gilah Gee

United States Circuit Judge

APPENDIX C

IN THE UNITED STATES DISTRICT COURT FOR
THE WESTERN DISTRICT OF LOUISIANA
SHREVEPORT DIVISION

Civil Action No. 82-2437

ARKLA, INC.

VERSUS

UNITED STATES OF AMERICA

U.S. DISTRICT COURT
WESTERN DISTRICT OF LOUISIANA
FILED
AUG 6, 1984
ROBERT H. SHEMWELL, CLERK
BY _____
Deputy

MEMORANDUM RULING

INTRODUCTION

This case involves an action by Arkla, Inc., seeking a refund of United States income taxes paid for the tax year 1980. The amount of the refund requested is $1,129,746.37. This request was filed with the Internal Revenue Service on September 16, 1981 in the form of an amended corporate income tax return, Form 1120X. The IRS determined that a refund was not proper, and denied Arkla's request. This lawsuit followed in October 1982.

Pending for determination are cross motions for summary judgment. It was determined at a pretrial conference that

there were no genuine issues of material fact, and that the resolution of this dispute hinged on a determination of law to be made by this court. For the reasons set forth below, the motion for summary judgment on behalf of Arkla, Inc. is GRANTED, and the government's motion for summary judgment is DENIED.

STIPULATED FACTS

In the pretrial order filed by the parties in December 1983, extensive fact stipulations were set forth which provide a thorough background of this income tax refund dispute. In addition to the stipulations of fact, the parties include a helpful list of definitions explaining terms involved in the case. The stipulated definitions are as follows:

1. "Cushion gas" is natural gas contained in a gas storage facility which provides a minimum pressure for the facility. This gas is sometimes referred to in the gas industry as "base gas."

2. "Working gas" is natural gas contained in a gas storage facility which is stored for delivery into a gas transmission system at times of high demand, principally during the winter heating season, and which will be replaced at times of low demand, principally during the summer season. This gas is sometimes referred to in the gas industry as "top gas."

3. "Native gas" is natural gas contained in a gas storage facility which was present in an underground reservoir at the time such reservoir was acquired or converted for use as a part of a gas storage facility.

4. "Injected gas" is natural gas contained in a gas storage facility which has been injected into the facility from some outside source.

5. "Non-recoverable gas" is natural gas contained in a gas reservoir which cannot be economically withdrawn.

With these stipulated definitions, a reasonably clear understanding of the dispute can be gained from the following 41 stipulated facts extracted verbatim from the Pretrial Order:

1. Plaintiff is an integrated natural gas company, within the meaning of the Natural Gas Act, subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC").

2. In a continuing effort to meet the needs of providing gas service to its more than 650,000 customers in its five state service area of Arkansas, Kansas, Louisiana, Oklahoma and Texas during winter heating periods, the Plaintiff, in 1976, made an extensive reevaluation and update of its gas storage needs and concluded that its minimal projected future needs would be for an additional 12 billion cubic feet ("BCF") of stored working gas with daily deliverability of approximately 240 million cubic feet ("MMCF").

3. As a part of its ongoing studies, by early 1977 the Plaintiff had evaluated approximately 50 potential storage reservoirs in its service area which were reasonably accessible to the Plaintiff's major transmission lines, but had not located any significant prospects meeting its general specifications for a gas storage facility.

4. In January of 1977, the Plaintiff engaged the services of Keplinger and Associates, Inc. of Tulsa, Oklahoma to assist with the further search and evaluation of the potential gas storage prospects, particularly analyzing reservoirs which were reasonably accessible to one of its major transmission lines.

5. Under letter of July 22, 1977, Keplinger and Associates advised the Plaintiff of three potential prospects meetings its general specifications: Centrahoma 1 (McLisk formation), Centrahoma (Oil Creek formation), and Chiles Dome (Wapanucka formation).

6. Pursuant to Plaintiff's request, Keplinger and Associates prepared and furnished in November 1977, a comprehensive geological feasibility study for converting the Chiles Dome reservoir into a gas storage facility.

7. The results of the Keplinger study and the Plaintiff's research into all aspects of its gas storage facilities were consol-

idated and formalized in the January 1978 publication by the Plaintiff's Long Range Planning department entitled "A Definition of Future Underground Storage Needs and a Recommended Plan for Meeting These Needs." The January 1978 report, which took into consideration the further expansion of an existing gas storage facility owned by Plaintiff, located near Ada, Oklahoma (the "Ada Storage Facility"), which had previously been expanded in 1976, revised the Plaintiff's minimum additional storage needs and set as a goal the addition of storage capacity sufficient to increase peak deliverability by 150 MMCF per day and to store an additional 14.2 BCF of working gas.

8. The recommended plan set forth in the January 1978 study to meet the new storage goals was for the purchase of the Chiles Dome reservoir and the construction and development of the Chiles Dome gas storage facility in Eastern Oklahoma, and the connection thereof with the Plaintiff's existing transmission system, together with a further expansion in the capacity of the Ada Storage Facility.

9. From the inception of the Chiles Dome studies, projections of the optimal cost of service for each prospect were determined, taking into consideration the varying factors and costs, including but not limited to the cost of various quantities of cushion gas and inversely the quantity of surface compression horsepower required; those projections for the Chiles Dome reservoir were set forth in the January 1978 report of the Long Range Planning department.

10. The authorization to commence with a more detailed study of both the technical (geological and engineering) and economic feasibility of converting the Chiles Dome reservoir into a gas storage facility was given in February 1978 and contact with the operator of the Chiles Dome field was made to secure initial source data.

11. The Plaintiff began the acquisition and review of the seismic data and well operational data of the Chiles Dome reservoir in the Spring of 1978.

12. The initial outward step in the acquisition and construction of the storage facility was the acquisition of the storage rights and necessary surface acreage, which actions included the following:

A. After negotiations with the five principal owners of the surface acreage under which the Chiles Dome reservoir lay (A.D. Cody and his wife, Joy Cody; Phillip R. Cody and his wife, Cynthia Cody; and N.B. Hunt), Plaintiff acquired, by Gas Storage Agreement dated June 13, 1978, from A.D. Cody, Joy Cody, Phillip R. Cody and Cynthia Cody for the cash consideration of $283,082.40 ($80.00 per surface acre) the right to inject natural gas into the Wapanucka Zone underlying 3,538.53 acres described in the Gas Storage Agreement, the right to store natural gas therein, to withdraw and produce gas therefrom and to do all things necessary in the construction and operation of a gas storage facility. Plaintiff was required, however, to pay the vendors the additional sum of $1,100.00 for each well drilled on the 3,538.53 acres and $10.00 per rod, or $666.00 per acre, for surface damage resulting from laying pipelines upon those properties or for other damages thereto.

B. After further negotiations, by Gas Storage Agreement dated September 27, 1979, Plaintiff obtained from N.B. Hunt for the cash consideration of $115,092.00 ($80.00 per surface acre) similar rights as had been obtained from the Cody family, namely the right to inject natural gas into the Wapanucka Zone underlying 1,438.65 acres described in the Gas Storage Agreement, the right to store natural gas therein, to withdraw and produce gas therefrom and to do all things necessary in the construction and operation of a gas storage facility. Plaintiff was required, however, to pay N. B. Hunt the additional sum of $1,000.00 for each well drilled on the 1,438.65 acres and $8.00 per rod, or $533.00 per acre, for surface damage resulting from laying pipelines upon those properties or for other damages thereto.

C. By warranty deed dated June 13, 1978, Plaintiff acquired from A.D. Cody and Joy Cody fee title to a 40 acre tract of land located in the East 20 acres of Lot 4 and West Half of the Southeast Quarter of the Southwest Quarter (W/2 of SE/4 of SW/4) section 19, Township 3 North, Range 10 East, Coal County, Oklahoma, for the cash consideration of $40,000.00, subject to the specific right of reversion to the vendors of the property upon abandonment of the gas storage facility underlying the property, which property was acquired by Plaintiff to serve as the primary surface compressor site for the Chiles Dome gas storage facility.

D. For the total cash consideration of $3,200.00, Plaintiff acquired storage rights, and associated leases, from the remaining land owners similar to those acquired from the Cody family and Mr. Hunt.

13. By an Assignment and Bill of Sale, dated June 13, 1978, Plaintiff acquired from A.D. Cody, for the cash consideration of $10.00, all of his right, title and interest in and to the Cody Gas Unit III, Well No. 1.

14. Plaintiff acquired from Elliott Davis, and others, for the cash consideration of $9,514.00, all of the owners' right, title and interest in and to the Davis Brothers-Cody Well No. 1 and the leases associated therewith covering approximately 137 net mineral acres.

15. On September 27, 1978 the Plaintiff applied to the FERC (FERC Docket No. CP78-540) for a temporary emergency certificate for authority to drill five test wells to confirm and develop additional reservoir data; the temporary certification for the five test wells was granted on October 26, 1978 with permanent authorization being granted pursuant to order dated December 15, 1978.

16. On October 6, 1978, the Plaintiffs Long Range Planning department published a Summary Report on the Chiles Dome Project in which each of the three major phases of the project,

the construction of the gas storage facility itself with all of its component parts, the modification of 16.7 miles of Line "O" Loop, and the installation of a 4,250 horsepower compressor at the Chambers, Arkansas compressor station, were evaluated and various options analyzed.

17. On October 31, 1978, the Plaintiff filed its Original Application for Certificate of Public Convenience and Necessity (FERC Docket No. CP 79-47), in which authority to construct the Chiles Dome Project was sought to consist of the following facilities: (a) the acquisition of storage rights, working interests and necessary surface acreage; (b) 20 injection-withdrawal wells (15 new wells to be drilled and 5 existing wells to be reworked) and one observation well; (c) a 6,750 horsepower compressor station; (d) a central point facility to perform measurement, pressure regulation, dehydration, liquid separation and other similar functions; (e) approximately 6.38 miles of 6" to 12" gathering lines to connect the wells to the compressor station; (f) approximately 11.14 miles of 16" pipeline to connect the compressor station to Plaintiff's existing transmission system; and (g) 14.0 BCF of cushion gas. In addition to the storage facilities incident to the Chiles Dome storage facility itself, the application also sought authority to construct 16.7 miles of 30" O.D. loop line paralleling one of Plaintiff's existing pipelines and a 4,250 horsepower centrifugal compressor station at a site in Northwest Arkansas to accommodate the additional deliverability volumes that would be available when the Chiles Dome storage facility became operational.

18. On May 8, 1979, Plaintiff filed with the FERC, under its Docket No. CP 79-47, an Amended Certificate Application for construction of the Chiles Dome Storage Facility, and on November 26, 1979 the FERC entered its "Findings and Order after Statutory Hearing Issuing Certificate of Public Convenience and Necessity and Granting Petition to Intervene," in which it found all the facilities described in Plaintiff's application, as set forth in 17 above, to be adequate and necessary to provide the increased deliverability and ordered the issuance of a certificate of public convenience and necessity for the construction and operation of the Chiles Dome project.

19. On November 1, 1979, Plaintiff filed with the Oklahoma Corporation Commission (as that state's Oil and Gas Commission), under the Commission's Docket No. 26599, its application to utilize the Chiles Dome reservoir (the Wapanucka formation thereof) as a gas storage facility and pursuant to order entered on November 21, 1979 by that Commission, the Commission found the necessity for the use of Chiles Dome as a gas storage reservoir superior to the necessity for the production of the remaining reserves and thus authorized the use of Chiles Dome (the Wapanucka formation thereof) for the underground storage of natural gas and authorized Plaintiff to expropriate the remaining native gas in the reservoir, if necessary, and fixed the quantities of recoverable native gas remaining in the reservoir as of April 30, 1979 at a total of 703,934 MCF.

20. Prior to entry of the Oklahoma Corporation Commission's order of November 21, 1979, Plaintiff had undertaken the voluntary acquisition (rather than resorting to expropriation) of the remaining native gas contained in the reservoir.

A. Atlantic Richfield Company (ARCO) was the operator of each of the producing units in the Chiles Dome Field and owned a 71.1599% working interest in the Cody Gas Unit #1 and the Cody Gas Unit #2 and owned the entire working interest of Cody Gas Unit #4.

B. By letter agreement dated November 22, 1978, Plaintiff agreed to purchase from ARCO all of its right, title and interest in and to any remaining recoverable native gas underlying the above-referenced units at the price of $0.33 per thousand cubic feet ("MCF") and agreed as to the method of determining such reserves; at closing on August 28, 1980, Plaintiff paid to ARCO the sum of $131,845.85 in fulfillment of that obligation.

C. IBEX, Inc. (IBEX) was the owner of a 14.4201% working interest in the Cody Gas Unit #1 and in the Cody Gas Unit #2; by letter agreement dated March 1, 1979, Plaintiff agreed to purchase from IBEX all of its right, title and interest in and to any remaining recoverable

native gas underlying the above-referenced units on the same terms and conditions as its agreement with ARCO and Plaintiff paid IBEX $28,527.00 on August 28, 1980 in fulfillment of that obligation.

D. Amoco Production Company (Amoco) was the owner of a 14.4200% working interest in the Cody Gas Unit #1 and in the Cody Gas Unit #2; by letter agreement dated June 5, 1979, Plaintiff agreed to purchase from Amoco all of its right, title and interest in and to any remaining recoverable native gas underlying the above-referenced units on the same terms and conditions as its agreement with ARCO and Plaintiff paid Amoco $28,527.00 on August 28, 1980 in fulfillment of that obligation.

E. In September, 1980, Plaintiff paid to the royalty owners the sum of $38,013.33 as their royalty interest for the remaining gas in the reservoir.

F. ARCO, as operator of the producing units of the Chiles Dome Field, had a contractual commitment with Boettcher Oil and Gas Company ("Boettcher") to deliver the remaining quantity of recoverable native gas in the Wapanucka formation of the Chiles Dome field to Boettcher at contractually agreed prices and pursuant to letter agreement dated November 22, 1978 between Plaintiff and ARCO, Plaintiff agreed to assume ARCO's obligations to Boettcher. In order to satisfy the contractual commitments with ARCO to deliver to Boettcher the remaining quantity of recoverable native gas in the Wapanucka formation of the Chiles Dome Field, and yet to retain that quantity of gas in the storage reservoir, Plaintiff:

1. Entered into a Gas Purchase Contract with ARCO agreeing to purchase the quantity of gas necessary to fulfill the contractual commitments to Boettcher, which gas was to be produced from the Chiles Dome Field but from a formation other than the Wapanucka formation, and Plaintiff was to pay ARCO the maximum lawful price

therefor which could be charged pursuant to the Natural Gas Policy Act of 1978 as of the date of delivery thereof; and,

2. Entered into an Agreement with Boettcher, dated July 10, 1980, under which Plaintiff agreed to deliver a total of 432,000 MCF of gas to Boettcher at times and in amounts set forth in the Boettcher Gas Purchase Contract dated August 5, 1964, with Boettcher paying to Plaintiff $0.53 per MCF, escalating $0.03 per MCF annually effective January 1, 1981.

21. Prior to its filings with the FERC and the Oklahoma Corporation Commission, Plaintiff had prepared extensive studies to determine the most economical method of constructing the gas storage facility within the parameters of approximately 11.5 to 12 billion cubic feet of working gas, minimum daily deliverability of 125 MMCF and at least a pressure of 610 pounds per square inch, gauge ("psig") for injection into the Plaintiff's transmission line number "AD." Those studies showed, as refined to the date of filing with the FERC for its certification, that the lowest cost of service per MCF was obtained by the utilization of an average minimum wellhead flowing pressure of 355 psig, which required 14 BCF of cushion gas for the flow rates involved, and the availability of 6,750 horsepower of surface compression.

22. The largest single item of cost for the construction of the Chiles Dome gas storage facility, regardless of the wellhead pressure considered, was the cushion gas.

23. On August 7, 1980, the Plaintiff notified the FERC that construction of the Chiles Dome gas storage facility was completed on July 30, 1980 and placed in service on that date.

24. During the calendar year 1980, Plaintiff purchased at a cost of $9,689,239.16 and injected into Chiles Dome 5,979,277 MCF of cushion gas as part of that storage facility, and purchased at a cost of $328,305.20 the 3,499,381 MCF of native gas remaining in the storage reservoir as of the date of closing with ARCO, IBEX and Amoco.

25. The 5,979,277 MCF of cushion gas purchased and injected into Chiles Dome by Plaintiff during 1980 is classified as recoverable cushion gas and, pursuant to the FERC Uniform System of Accounts, the $9,689,239.16 cost thereof is included in FERC Account #117—Gas Stored Underground-Noncurrent, which is one of the "Utility Plant" accounts.

26. The 3,499,381 MCF of native gas remaining in Chiles Dome and purchased by the Plaintiff in 1980, consisted of 512,774 MCF of recoverable native gas and 2,986,607 MCF of non-recoverable native gas. The $134,642.29 cost of the recoverable native gas is included in FERC Account #117—Gas Stored Underground-Noncurrent and the $193,662.91 cost of the non-recoverable native gas is included in FERC Account #352.3—Non-Recoverable Gas, which account is also one of the "Utility Plant" accounts. The cost of the recoverable native gas was adjusted in subsequent years to account for the additional cost incurred by Plaintiff in performing on the Boettcher contract (the difference between the amounts paid to ARCO [Paragraph 20(F)(1) above] and the amounts received from Boettcher [Paragraph 20(F)(2) above]).

27. The cushion gas, whether recoverable or non-recoverable, is an integral part of the Chiles Dome gas storage facility and is classified pursuant to the FERC Uniform System of Accounts as part of the "Utility Plant."

28. Plaintiff was required to pay and paid fees to the FERC, under the provisions of 18 CFR § 159.2(a) and § 159.2(b), based on the cost of construction of the Chiles Dome facility which cost of construction included the cost of the native and injected cushion gas, both recoverable and non-recoverable.

29. The cost of cushion gas, both recoverable and non-recoverable, constitutes a part of the gas utility plant and is included as such in the rate base under the provisions of 18 CFR § 154.63(f).

30. The recoverable cushion gas carried in the Plaintiff's FERC Account #117 is part of the property pledged to secure

the payment of the Plaintiff's bond indebtedness under the Eleventh Supplemental Indenture by and between Arkansas Louisiana Gas Company and Morgan Guaranty Trust Company of New York and Commerce Bank of Kansas City dated as of September 1, 1970 (Supplemental to Indenture dated as of September 1, 1953), as Trustee, and cannot be sold or otherwise disposed of by the Plaintiff except with consent of the Trustee under the terms and conditions of the Indenture.

31. Both recoverable and non-recoverable cushion gas serve the same function in a gas storage facility.

32. The cushion gas, both recoverable and non-recoverable, and surface compression serve the same general function in a gas storage facility.

33. The cushion gas, both recoverable and non-recoverable, contained in the Chiles Dome gas storage facility is tangible property used as an integral part of furnishing gas services and the transportation of gas; additionally, it is a part of a facility the whole of which constitutes a natural gas bulk storage facility used by Plaintiff in its business of furnishing gas service.

34. The cushion gas, both recoverable and non-recoverable, contained in the Chiles Dome gas storage facility is not a building or its structural component.

35. In its final design, the Chiles Dome gas storage facility was to store 12 BCF of working gas with minimum daily deliverability of 133 MMCF to provide for approximately 90 days of peak demand.

36. The cost of working gas, when injected into an underground storage facility, is carried in FERC Account #164.1 Gas Stored Underground-Current, which is one of the "Current and Accrued Asset" inventory accounts.

37. The Plaintiff is an accrual basis taxpayer with its tax year ending on December 31 of each year which files an annual Form 1120, U.S. Corporate Income Tax Return with the Internal

Revenue Service in Austin, Texas on the extended due date thereof of September 15 of the year following the close of the tax year.

38. On its Form 1120 timely filed for the tax year 1978, the Plaintiff elected under the provisions of Section 46(d)(6) of the Code [26 U.S.C. § 46(d)(6)] to claim investment tax credit on qualified progress expenditures in connection with the construction of the Chiles Dome gas storage facility.

39. Plaintiff established, maintained and fully funded for the taxable year 1980, an employee stock ownership plan satisfying the provisions of Section 48(n)(1)(B) of the Code [26 U.S.C. § 48(n)(1)(B)] regarding the qualified matching employee contributions, and was thus entitled to investment tax credit at the rate of 11½% of its qualified investment property additions for its taxable year 1980.

40. The Plaintiff on its timely filed Form 1120 for the taxable year 1980 claimed investment tax credit on the $193,662.91 cost of the 2,986,607 MCF of non-recoverable native cushion gas contained in the Chiles Dome facility which credit was allowed by the Defendant in the total amount of $22,271.23.

41. The Plaintiff on the Form 1120X for the taxable year 1980, filed on September 16, 1981, claimed additional investment tax credit in the amount of $1,129,746.37 based on the $134,642.29 cost of the 512,774 MCF of recoverable native cushion gas contained in the Chiles Dome facility and the $9,689,239.16 cost of the recoverable cushion gas injected into the Chiles Dome facility.

LEGAL ISSUES

The pivotal legal issue to be resolved is whether recoverable cushion gas is an asset (1) which has a useful life of more than seven years and (2) is property with respect to which depreciation is allowable (both requirements being set forth in Internal Revenue Code ("IRC"), § 48(a)(1)). If the recoverable cushion gas is subject to depreciation and has a useful life of more than seven years [See, IRC § 46(c)], Arkla is entitled to an invest-

ment tax credit for tax year 1980, as provided for in IRC § 38. Thus, if Arkla is entitled to an investment tax credit for its investment in recoverable cushion gas, it is entitled to a refund on its 1980 income tax return in the stipulated amount of $1,129,746.37, plus legal interest.

ANALYSIS:

1. Burden of Proof

In an action in which a taxpayer seeks a refund of income taxes paid, the taxpayer has the burden of proof of establishing his right to recovery. In the case of *Mallette Brothers Construction Co., Inc. v. United States*, 695 F.2d 145 (5th Cir. 1983), the court set out this burden:

> A taxpayer seeking a refund must demonstrate not only the error in the asserted deficiency but also the amount of the refund to which he is entitled, *i.e.*, the correct amount of his tax liability.

695 F.2d at 149; *U.S.A. v. Janis*, 428 U.S. 433, 96 S.Ct. 3021 (1976). In the case at bar, the parties have stipulated the amount of refund to which Arkla is entitled if it prevails on the merits. Therefore, Arkla need only establish that it is entitled to the refund claimed as a matter of law.

This is not a case in which a taxpayer challenges the validity of a portion of the IRC or a regulation promulgated thereunder. For this reason, there is no need to address the issues raised by the government in its brief concerning the presumed validity of a Code provision or an IRS regulation. The sole issue is whether the cost of recoverable cushion gas is subject to an investment tax credit under the appropriate Code provisions.

2. Statutory provisions

The court concurs in Arkla's assertion in its memorandum in support of the motion for summary judgment that the IRC provisions applicable in this case are "virtually indecipherable." However, there is no disagreement between the parties

as to which portions of the Code govern the outcome of this case.

Provisions for an investment tax credit are made in IRC § 38, which states, "there shall be allowed, as a credit against a tax imposed by this chapter, the amount determined under Subpart B of this part." Subpart B includes IRC §§ 46-48, and makes an attempt to specify rules controlling the investment tax credit.

Arkla and the government have stipulated in the Pretrial Order that cushion gas satisfies the requirements of IRC § 48(a)(1)(B)(iii). The effect of this stipulation is to classify cushion gas as "Section 38 property," defined as property for which investment tax credit is allowable.

In addition to the above classification, the cushion gas at issue here must meet the requirements of the last sentence of IRC § 48(a)(1), which states:

> Such term [Section 38 property] includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of three years of more.

In order to take the full amount of the investment tax credit, IRC § 46(c) requires that the subject property have an estimated useful life of more than seven years.

The statutory provisions bring into focus the critical issue to be resolved in this case: whether recoverable cushion gas is subject to depreciation and has an estimated useful life of more than seven years. Arkla argues in the affirmative on both questions, while the government takes a position to the contrary.

3. Statutory Application

A. Cushion Gas as Inventory

As a preliminary point, it appears that the government has abandoned its early position that recoverable cushion gas con-

stitutes an item of inventory. The key determination to be made when classifying an asset as inventory is to ascertain the purpose for which the asset was acquired. There is no question that the cushion gas, both recoverable and non-recoverable, was acquired by Arkla for the purpose of ensuring sufficient pressure in the Chiles Dome facility to provide the optimum deliverability of natural gas to Arkla's customers. The stipulations in the Pretrial Order make it clear that the cushion gas was not purchased for resale in the ordinary course of Arkla's business.

Revenue Ruling 79-188 is authority for the proposition that cushion gas is not inventory:

> Section 471 of the Code and regulations thereunder provide that raw materials are inventoriable only if they have been acquired for the purpose of sale in the ordinary course of business or for the purpose of being physically incorporated into merchandise intended for sale. Consequently, the purpose for which raw material is purchased is a major factor in determining whether such material is inventoriable by the taxpayer. *See Latimer-Looney Chevrolet, Inc. v. Commissioner*, 19 C.C. 120 (1952), acq. 1953-1, C.B. 5.

79-1 C.B. 191. Since the cushion gas purchased by Arkla had the specific purpose of providing a required pressure base in the Chiles Dome facility, it must be classified as a capital asset, and not an item of inventory.

B. Depreciation of Cushion Gas

IRC § 167 provides the guidelines for determining whether depreciation can be allowed on a particular asset. Subsection 167(a) specifies:

> There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income.

There is no question that the Chiles Dome facility and the cushion gas therein is property used in Arkla's trade or business, and is property held for the production of income. The government, however, argues that cushion gas is not an asset subject to exhaustion, wear and tear, or, presumably, obsolescence.

The fact stipulations in the Pretrial Order indicate that the government allowed an investment tax credit for *non-recoverable* cushion gas contained in the Chiles Dome facility. This allowance implies that the cushion gas, at least the non-recoverable component, is subject to depreciation. For the government to argue that natural gas, as a generic entity, is not subject to depreciation because it never wears out contradicts its allowance of an investment tax credit for the non-recoverable cushion gas.

The government's assertions are also inconsistent with the holding by the Court of Claims in the analogous case of *Transwestern Pipeline Company v. U.S.A.*, 639 F.2d 679 (Ct. Cl. 1980). The *Transwestern* case overruled Revenue Ruling 68-620 which classified "line pack gas" in an interstate gas pipeline as "merchandise in transit." Line pack gas is that quantity of natural gas pumped into an interstate pipeline which produces sufficient line pressure to allow natural gas to be transmitted through the pipeline. The *Transwestern* court expressly stated that line pack gas and cushion gas in underground storage facilities performed precisely the same function. Without line pack gas or cushion gas, these natural gas facilities would be non-functional. Thus, the *Transwestern* court held that line pack gas was a capital asset and not merchandise in transit. The court went on to provide that depreciation would be allowable on the line pack gas, a holding which cannot be reconciled with the government's contentions that the cushion gas is not subject to depreciation.

C. Salvage Value of Cushion Gas

In *Transwestern*, the court also addressed an issue raised by the government in this case. Specifically, the government as-

serts that depreciation is not allowable on the cushion gas because the salvage value would be greater than or equal to the original cost of the cushion gas. Superficially, this argument is attractive. However, logical analysis reveals a serious flaw. The government attempts to differentiate between recoverable and non-recoverable cushion gas, although each performs precisely the same function in the underground gas storage facility. The *Transwestern* case did not distinguish between recoverable and non-recoverable line pack gas. The court determined that the proper methodology for computing salvage value would be to deduct the value of recoverable line pack gas from the total cost of line pack gas. This court finds that such a "net" approach to determining the salvage value of Arkla's cushion gas is appropriate here.

The total cost of Arkla's cushion gas must be computed to be the cost of purchasing the native cushion gas, plus the cost of the cushion gas injected into the Chiles Dome facility. It is important to remember that without the cushion gas, recoverable *and* non-recoverable, the facility could not serve its designed purpose. [*See*, Discussion in Arkla's Memorandum in Support of Motion for Summary Judgment, pp. 9-10, and affidavit of Edward N. Henderson, pp. 8-9, Exhibit No. 1, Arkla's Memorandum.] Thus, it is inappropriate to distinguish between recoverable and non-recoverable cushion gas for computing the salvage value. Thus, the salvage value of the Chiles Dome cushion gas is the total cost of *all* cushion gas, less the value of the recoverable cushion gas. The result of this computation is the non-recoverable portion of the cushion gas in the Chiles Dome facility. This is the quantity of gas upon which the government has *already* allowed an investment tax credit, and for which, presumably, depreciation is allowable.

An analogy to another type of business is appropriate to explain this court's perception of the issues involved here. Assume that a taxpayer is in the business of steel fabrication. In order to build a facility in which to fabricate steel, the taxpayer must purchase fabricated steel to erect the facility. There can be no question that the steel fabricator would be

allowed depreciation on the newly constructed facility, and that the salvage value of the fabricated steel used in the facility would be used in the depreciation computations. The fact that the taxpayer is in the steel fabrication business has no impact on this salvage value computation. An identical result would occur when a construction salvage contractor who sells used brick uses brick to build his place of business.

D. Useful Life of Cushion Gas

The government asserts another argument that the cushion gas has no fixed or determinable useful life; therefore, it cannot be Section 38 property. Again, the government's argument falls under its own weight. It is difficult to comprehend how the government could allow an investment tax credit on the non-recoverable cushion gas, and argue that the recoverable cushion gas has no useful life and is not subject to the investment tax credit.

In the *Transwestern* case, the court found that line pack gas had the same useful life as the pipeline into which the gas was injected. Similarly, the cushion gas used in the Chiles Dome facility must have a useful life equal to that of the facility and its related pipelines. In this case, Arkla has submitted the deposition of Dr. Mehmet Rasin Tek. Dr. Tek reiterates the *Transwestern* determination that line pack gas and cushion gas perform identical functions. He also establishes that the purposes of recoverable and non-recoverable cushion gas are the same. More importantly, Dr. Tek is of the opinion—an opinion shared by this court—that the useful life of the Chiles Dome facility and its related pipelines is between 40 and 50 years. This opinion is unrebutted by the government.

Arkla has also submitted the affidavit of Edward N. Henderson, a mechanical engineer and vice president of Arkla, Inc. In his affidavit, Mr. Henderson discussed the useful life computations made on Arkla's transmission lines related to the Chiles Dome facility. Based on these computations and studies made by an independent engineering firm, Mr. Henderson asserted that the transmission lines have an approximate useful life of

51.7 years. This court is convinced, as was the *Transwestern* court, that the useful life of cushion gas is equal to the useful life of the storage facility in which it is contained, which includes the pipelines associated with the facility.

In order to qualify for the full investment tax credit, the capital asset must have a useful life in excess of seven years. Arkla has established that the estimated useful life of the Chiles Dome facility and its associated pipelines and, logically, the cushion gas in the facility, has an estimated useful life well in excess of seven years. The only reasonable conclusion is that the cushion gas qualifies for the investment tax credit.

Treasury Regulation 1.167(a)-1(b) contains language which reinforces this conclusion that the cushion gas has a determinable useful life, and that that useful life is in excess of seven years:

> [T]he estimated useful life of an asset is not necessarily the useful life inherent in the asset *but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.*

(Emphasis added.) In this case, the natural gas at issue was purchased for the purpose of increasing the subsurface pressure in the Chiles Dome facility. This cushion gas will be useful to Arkla for this purpose *only* as long as the Chiles Dome facility and its associated pipelines are in use. As noted above, the cushion gas has a determinable useful life—a useful life of more than seven years.

SUMMARY:

As noted by the parties, there are no judicial pronouncements in the jurisprudence on the issue of whether cushion gas is a capital asset subject to depreciation and the investment tax credit. However, the *Transwestern* case provides an excellent analogy, and is persuasive in the resolution of the dispute in this case. Further, the court relies on common sense in determining that cushion gas must be considered as a capital asset, and that

the Chiles Dome facility, the related pipelines and the cushion gas must be considered a "system" of component parts. In the case of *Glaze v. U.S.*, 641 F.2d 339 (5th Cir. 1981), the court approved the use of common sense in resolving facially confusing tax issues:

> One must be careful not to stray too far into the forest of technical legal reasoning so as to obscure the light of common sense. Common sense should play a part in all court decisions, including those involving the construction of tax statutes.

641 F.2d at 344.

The application of common sense leads inexorably to the conclusion that recoverable cushion gas is a capital asset; is subject to depreciation; has a determinable useful life in excess of seven years; and constitutes Section 38 property. To distinguish between recoverable and non-recoverable cushion gas, and to allow depreciation and the investment tax credit on one but not the other, flies in the face of common sense.

CONCLUSION

For the reasons set forth above, the motion for summary judgment on behalf of Arkla, Inc. is GRANTED, and the motion for summary judgment on behalf of the United States is DENIED. According to the stipulations in the Pretrial Order, judgment is entered in favor of Arkla in the amount of $1,129,746.37, plus legal interest. An Order consistent with this Memorandum Ruling will issue herewith.

THUS DONE AND SIGNED at Shreveport, Louisiana, this 6th day of August, 1984.

/s/ Tom Stagg

TOM STAGG, CHIEF JUDGE

APPENDIX D

IN THE UNITED STATES DISTRICT COURT FOR
THE WESTERN DISTRICT OF LOUISIANA
SHREVEPORT DIVISION

Civil Action No. 82-2437

ARKLA, INC.
VERSUS
UNITED STATES OF AMERICA

U.S. DISTRICT COURT
WESTERN DISTRICT OF LOUISIANA
FILED
AUG 6, 1984
ROBERT H. SHEMWELL CLERK
BY_____
DEPUTY

ORDER

For the reasons set forth in the foregoing Memorandum Ruling,

IT IS ORDERED that the motion for summary judgment on behalf of Arkla, Inc. is GRANTED, and the motion for summary judgment on behalf of the United States of America is DENIED.

IT IS FURTHER ORDERED that judgment is entered in favor of Arkla, Inc. pursuant to fact stipulations in the Pretrial Order in the amount of $1,129,746.37, plus legal interests.

DATED AND SIGNED at Shreveport, Louisiana, this 6th day of August, 1984.

/s/ Tom Stagg

TOM STAGG, CHIEF JUDGE

APPENDIX E

IN THE UNITED STATES DISTRICT COURT FOR
THE WESTERN DISTRICT OF LOUISIANA
SHREVEPORT DIVISION

Civil Action No. 82-2437

ARKLA, INC.

VERSUS

UNITED STATES OF AMERICA

JUDGMENT

Considering the ruling of the United States Court of Appeals for the Fifth Circuit, mandated on September 3, 1985,

IT IS ORDERED, ADJUDGED AND DECREED that all claims and demands of ARKLA, INC. are DENIED on the merits.

THUS DONE AND SIGNED in Shreveport, Louisiana, this the 10th day of September, 1985.

/s/ Tom Stagg

TOM STAGG, CHIEF JUDGE

APPENDIX F

§ 38. Investment in certain depreciable property

(a) General rule.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

(b) Regulations.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

APPENDIX G

§ 48. Definitions; special rules

(a) Section 38 property.—

(1) In general.—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property (other than an air conditioning or heating unit), or

(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state), or

(C) elevators and escalators, but only if—

(i) the construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date, or

(D) single purpose agricultural or horticultural structures; or

(E) in the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified re-

habilitation expenditures (within the meaning of subsection (g)).

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more.

APPENDIX H

§ 167. Depreciation

(a) General rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

APPENDIX I

§ 1.48—1 Definition of section 38 property

(a) In general. Property which qualifies for the credit allowed by section 38 is known as "section 38 property". Except as otherwise provided in this section, the term "section 38 property" means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 3 years or more (determined as of the time such property is placed in service), and (3) which is either (i) tangible personal property, (ii) other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or is a research or storage facility used in connection with any of the foregoing activities, or (iii) an elevator or escalator which satisfies the conditions of section 48(a) (1) (C). The determination of whether property qualifies as section 38 property in the hands of the taxpayer for purposes of the credit allowed by section 38 must be made with respect to the first taxable year in which such property is placed in service by the taxpayer. See paragraph (d) of § 1.46—3. For the meaning of "estimated useful life", see paragraph (e) of § 1.46—3. In the case of property which is not described in section 50, this paragraph shall be applied by substituting "4 years" for "3 years".

(b) Depreciation allowable. (1) Property is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 and the basis (or cost) of the property is recovered through a method of depreciation, including, for example, the unit of production

method and the retirement method as well as methods of depreciation which measure the life of the property in terms of years. If property is placed in service (within the meaning of paragraph (d) of § 1.46-3) in a trade or business (or in the production of income), but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins in a taxable year subsequent to the taxable year in which such property is placed in service, then a deduction for depreciation shall be treated as allowable with respect to such property in the earlier taxable year (or years). Thus, for example, if a machine is placed in service in a trade or business in 1963, but the period for depreciation with respect to such machine begins in 1964, because the taxpayer uses an averaging convention (see § 1.167 (a)-10) in computing depreciation, then, for purposes of determining whether the machine qualifies as section 38 property, a deduction for depreciation shall be treated as allowable in 1963.

(2) If, for the taxable year in which property is placed in service, a deduction for depreciation is allowable to the taxpayer only with respect to a part of such property, then only the proportionate part of the property with respect to which such deduction is allowable qualifies as section 38 property for the purpose of determining the amount of credit allowable under section 38. Thus, for example, if property is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of the basis (or cost) of such property qualifies as section 38 property. Further, property does not qualify to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

APPENDIX J

§ 1.167(a)—2 INCOME TAX REGULATIONS

§ 1.167(a)—2 Tangible property

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical developments or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residsence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

No. 85-855

Supreme Court, U.S.
FILED
FEB 18 1986
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1985

ARKLA, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly held that economically recoverable natural gas used as "cushion gas" to maintain pressure in an underground gas storage facility is not "property with respect to which depreciation * * * is allowable," so that it is not eligible for the investment tax credit.

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In the Supreme Court of the United States

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No. 85-855

ARKLA, INC., PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-7a) is reported at 765 F.2d 487. The opinion of the district court (Pet. App. 9a-29a) is reported at 592 F. Supp. 502.

JURISDICTION

The judgment of the court of appeals was entered on July 15, 1985. A timely petition for rehearing (Pet. App. 8a) was denied on August 20, 1985. The petition for a writ of certiorari was filed on November 18, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner supplies natural gas to customers in five southwestern states. To provide for future gas storage needs, petitioner decided to convert an underground natural gas reservoir in eastern Oklahoma, known as the "Chiles Dome," into a gas storage facility. Petitioner acquired from

the surface owners the right to store gas in the formation, as well as surface rights for drilling wells, laying pipe, and constructing gathering and transmission lines (Pet. App. 2a, 11a-14a). Petitioner also acquired, in fee, a 40-acre tract of land to serve as the compressor site (*id.* at 14a).

In order to operate the storage facility at peak efficiency, petitioner determined that it would be necessary to maintain a certain minimum gas pressure at the intake side of the compressors pumping gas out of the facility into the attached delivery lines. To achieve that pressure, petitioner maintains in the facility a volume of natural gas called "cushion gas" (Pet. App. 2a, 24a). "Cushion gas" is physically indistinguishable from natural gas generally; the term simply refers to the *volume* of gas needed to maintain the desired pressure in the storage chamber (*id.* at 2a, 10a). During 1980, the year the Chiles Dome facility was placed in service, petitioner provided the requisite amount of "cushion gas" by purchasing the native gas already present in the reservoir, and then injecting additional gas purchased from other sources (*id.* at 2a, 18a).

Petitioner created two separate accounting categories for its acquired cushion gas. These categories distinguished between "recoverable" cushion gas (gas that will be commercially removable and marketable when the reservoir is no longer used as a storage facility) and "nonrecoverable" cushion gas (gas that will be lost forever in the storage chamber). See Pet. App. 2a-3a. This separate accounting treatment for "recoverable" and "nonrecoverable" cushion gas was consistent with, and was mandated by, the uniform system of accounts prescribed by FERC. See Pet. App. 3a, 19a. The cost of the cushion gas that petitioner deemed "nonrecoverable" was $193,663. The cost of the cushion gas that petitioner deemed "recoverable" was $9,823,881 (*ibid.*).

2. Section 38 of the Internal Revenue Code[1] provides an "investment tax credit." Property qualifying for the credit is called "section 38 property," and "section 38 property" is defined to include tangible property that "constitutes a facility used * * * for the bulk storage" of gas in connection with the furnishing of gas services. See I.R.C. § 48(a)(1)(B)(i) and (iii). "Section 38 property" is further defined to "include[] only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable" (I.R.C. § 48(a)(1) (penultimate sentence)). The allowance for depreciation is governed by Section 167(a) of the Code, which permits as a deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in profit-making endeavors.

On its original 1980 federal income tax return, petitioner claimed an investment tax credit for the cost of the nonrecoverable cushion gas in its Chiles Dome facility. The credit so claimed was in the amount of $22,271, and it was allowed by the Commissioner. See Pet. App. 3a, 21a. Petitioner subsequently filed an amended 1980 return claiming an additional investment tax credit for the cost of the recoverable cushion gas in the facility. The additional credit claimed was in the amount of $1,129,746 (*ibid.*).

After six months passed without the Commissioner's acting on that claim (see I.R.C. § 6532(a)(1)), petitioner brought this refund suit in the United States District Court for the Western District of Louisiana. That court ruled for petitioner (Pet. App. 9a-29a). It rejected the Commissioner's argument that recoverable cushion gas, not being subject to "exhaustion, wear and tear [or] obsolescence"

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the period at issue (the Code or I.R.C.).

(I.R.C. § 167(a)), is not "depreciable property" that qualifies for the investment tax credit. Rather, relying on the fact that recoverable and nonrecoverable cushion gas are physically and functionally identical, the court held that no distinction should be made between them in determining whether they constitute depreciable property (Pet. App. 25a-29a). The court noted that the Commissioner treated petitioner's nonrecoverable cushion gas as depreciable property and hence had allowed an investment tax credit as to it (*id.* at 25a). Recoverable cushion gas, the court concluded, should be treated the same way (*id.* at 29a).

The court of appeals unanimously reversed (Pet. App. 1a-7a). The fact that "recoverable and nonrecoverable cushion gas are physically identical," the court held, "does not require them to be treated identically for depreciation purposes" (*id.* at 5a). To the contrary, the court reasoned (*id.* at 5a-6a), the principles that underlie the allowance for depreciation mandate that the two categories of gas be treated differently:

> The IRS allowed the investment tax credit for the nonrecoverable cushion gas Arkla claimed on its original 1980 federal income tax return because this gas will be unavailable for any use after the useful life of the storage facility ends. In essence, the useful life of the nonrecoverable gas is measured by the useful life of the storage facility. By contrast, the recoverable cushion gas will remain physically unchanged in the storage facility for an indefinite period of time. At any time that the storage facility is closed, the recoverable gas, by definition, will be available for sale or other use, with its general utility and value undiminished in any fashion. [The fact that] the nonrecoverable cushion gas will become obsolete along with the storage facility, while the recoverable cushion gas will not, mandates a

different treatment of the two assets for depreciation purposes.

ARGUMENT

The decision below is correct. Contrary to petitioner's assertion, there is no conflict among the circuits on the question presented. There is no basis for further review.

1. The question whether petitioner is entitled to an investment tax credit for the recoverable cushion gas turns on whether that gas is "property with respect to which depreciation * * * is allowable" within the meaning of Section 48(a)(1). To be depreciable, property must be subject to "exhaustion, wear and tear, [or] obsolescence." I.R.C. § 167(a). Recoverable cushion gas is plainly not subject to "wear and tear" or "exhaustion," because, as the court of appeals observed (Pet. App. 5a), it "will remain physically unchanged in the storage facility for an indefinite period of time." And the court was also correct in concluding that recoverable cushion gas is not subject to "obsolescence" —that is, to loss of value or usefulness because of changing circumstances[2] — because, when the storage facility is closed, "the recoverable gas, by definition, will be available for sale or other use, with its general utility and value undiminished in any fashion" (*id.* at 5a-6a). This result is in contrast to that with respect to the nonrecoverable cushion gas, the depreciability of which is unquestioned, since that gas by definition will *not* be available for any use once the facility is abandoned, but will be "lost" in the storage chamber.

The court of appeals observed that this common-sense result "is supported by several other considerations as well" (Pet. App. 6a). The depreciation deduction allowed by Section 167 is "designed to compensate a taxpayer for actual

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[2]See *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 15-17 (1940); *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 653-654 (1931).

economic loss" (Pet. App. 6a) by permitting him to recover, free from taxation, the capital that he has invested in the asset. *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960). The depreciation deduction represents a return to the taxpayer, over the property's useful life, of his investment in the property, less any "salvage" value that the property will likely have at the end of its useful life. See *id.* at 104-107; *Hertz Corp.* v. *United States*, 364 U.S. 122, 126-129 (1960). Accordingly, where it is clear that the taxpayer will suffer no economic loss (*e.g.*, where residual or salvage value equals or exceeds original cost), depreciation is not allowable. *E.g., Hibernia National Bank* v. *United States*, 740 F.2d 382, 386-387 (5th Cir. 1984); *Hawkins* v. *Commissioner*, 713 F.2d 347, 353-354 (8th Cir. 1983); *Kem* v. *Commissioner*, 432 F.2d 961, 963 (9th Cir. 1970). Here, because the recoverable cushion gas can be economically removed from the storage facility in the same condition that it was in at the time of its purchase, that gas "does not represent a potential economic loss" to petitioner (Pet. App. 6a). Depreciation for that reason is not allowable.[3]

The court of appeals' conclusion that the economic difference between recoverable and nonrecoverable cushion gas "mandates a different treatment of the two assets for depreciation purposes" (Pet. App. 6a) is likewise supported by the Treasury Regulations. They provide that "[t]he depreciation allowance in the case of tangible property applies *only to that part of the property* which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence." Treas. Reg. § 1.167(a)-2

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[3]Petitioner's somewhat confusing assertion (Pet. 4, 8, 19-20, 22) that the decision below conflicts with this Court's decisions regarding salvage value seems to be based on the argument that the gas storage facility must be treated as a single unit, rather than as an assemblage of components, for depreciation purposes. As we demonstrate below (pages 7-8, *infra*), that argument is incorrect.

(emphasis added). In specifying that depreciation is allowable only for "that part" of the property that is subject to exhaustion or decay, the Regulation makes it clear that the determination of depreciability must generally be made with respect to the property's separate components. The various components of petitioner's gas storage facility — *e.g.*, the cushion gas, as distinguished from the rest of the facility, and the recoverable cushion gas, as distinguished from the nonrecoverable portion — must thus be treated separately here.

Without specifically challenging the validity of this Regulation (see Pet. 11), petitioner argues that the recoverable cushion gas should not be analyzed separately, but rather that the entire gas storage facility should be deemed "the property" for depreciation purposes, with a single depreciation allowance being computed, claimed, and allowed on the facility as a whole. See Pet. 9, 14, 22, 25-27. This argument is plainly wrong. Petitioner's storage facility is divided into many parts, and the total cost of putting it into service included the cost of many items — land acquisition, acquisition of underground storage rights, construction of wells, purchase and installation of compressors and compressor stations, purchase and installation of various pipelines — besides the cost of the cushion gas (Pet. App. 13a-15a). Not all of these components qualify for depreciation — land obviously does not[4] — and the various components may have different useful lives. Thus, both the eligibility for depreciation and the actual depreciation allowances must *necessarily* be determined on a component-by-component basis. Since eligibility for the investment tax

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[4]See, *e.g.*, *Lomas Santa Fe, Inc.* v. *Commissioner*, 693 F.2d 71, 72 (9th Cir. 1982), cert. denied, 460 U.S. 1083 (1983); *A. Duda & Sons, Inc.* v. *United States*, 560 F.2d 669, 678 (5th Cir. 1977); *Bender* v. *United States*, 383 F.2d 656, 659 (6th Cir. 1967); *Hoboken Land & Improvement Co.* v. *Commissioner*, 138 F.2d 104, 106 (3d Cir. 1943).

credit depends on depreciability (I.R.C. § 48(a)(1)), and since the amount of the credit depends on the property's useful life (I.R.C. § 46(c)(2)), the investment-credit inquiry must necessarily be conducted on a component-by-component basis as well.

At bottom, petitioner seems to recognize that its position is untenable under traditional depreciation principles, and it accordingly argues that those principles should not apply in determining entitlement to the investment tax credit. "[T]he Fifth Circuit's utilization of the Code § 167 concepts and regulations," petitioner asserts, "is entirely misplaced for Section 38 purposes," on the theory that the two Sections, while having "the common thread and Congressional purpose to stimulate investment in productive resources," supposedly manifest a different "approach" (Pet. 12, 13). This argument is wholly insubstantial. Congress has clearly specified that the investment tax credit is available "only [as to] property with respect to which depreciation (or amortization in lieu of depreciation) is allowable" (I.R.C. § 48(a)(1) (penultimate sentence)). Since the allowance for depreciation is governed by Section 167 — a Section that is entitled "Depreciation" — the words that Congress has placed in Section 48(a)(1) necessarily require "utilization of the Code § 167 concepts and regulations" (Pet. 13) in answering the question presented here.

2. There is no merit to petitioner's contention (Pet. 21-22) that the decision below conflicts with *Transwestern Pipeline Co.* v. *United States*, 639 F.2d 679 (Ct. Cl. 1980). That case involved a depreciation deduction for "line pack" gas — natural gas that must initially be injected to fill gas pipelines and must remain in those pipelines to maintain customer service. The Court of Claims considered the "line pack" gas as a unit and held that it was a capital asset depreciable over the useful life of the pipeline system (*id.* at 680-681). The court found that, at the end of the pipeline's

useful life, 88% of the gas would be nonrecoverable and 12% would be recoverable. The court accordingly concluded that the "line pack" gas had a total salvage value equal to 12% of its original cost, and hence that the total depreciation had to be limited to 88% of the original cost (*id.* at 688). The effect of the Court of Claims' decision was thus to treat the entire line pack as "depreciable property," but to disallow depreciation on the recoverable portion of it.

The court below correctly held (Pet. App. 6a) that *Transwestern* "is distinguishable from the instant case." The government's sole argument in *Transwestern* was that *all* of the line pack gas constituted "inventory" and was thus entirely ineligible for depreciation. Under those circumstances, the analytical difference between the recoverable and the nonrecoverable gas was not important. It was immaterial whether the *Transwestern* court, in rejecting the "inventory" argument, held that the entire line pack was depreciable property, subject to a limitation on depreciation arising from the 12% salvage value, or whether it held that only the 88% nonrecoverable portion of the line pack was depreciable property, having no salvage value. In either event, the amount of the depreciation allowance would be exactly the same. Here, on the other hand, the investment credit outcome depends entirely on the characterization of the recoverable cushion gas as depreciable or nondepreciable property, and the instant case thus presents an issue that there was no need to decide in *Transwestern*.

Indeed, to the extent that any inference may be drawn from *Transwestern* about how the Court of Claims' successor would decide the question presented here, that opinion suggests that the Federal Circuit would reach the same result that the Fifth Circuit reached below. The *Transwestern* court, in holding the taxpayer entitled to depreciation to the extent the line pack gas was nonrecoverable, relied in part on a revenue ruling in which the Commissioner ruled

that nonrecoverable cushion gas in an underground gas storage facility is depreciable property whereas recoverable cushion gas is not. See 639 F.2d at 681 (citing Rev. Rul. 75-233, 1975-1 C.B. 95). The position that the Commissioner took in that ruling, of course, is identical to his position here. There is thus no reason to believe that the Federal Circuit would decide this case differently than the Fifth Circuit did.

3. Petitioner likewise errs in contending (Pet. 7-19) that the decision below conflicts with *Hawaiian Independent Refinery, Inc.* v. *United States*, 697 F.2d 1063 (Fed. Cir.), cert. denied, 464 U.S. 816 (1983), *Oglebay Norton Co.* v. *United States*, 610 F.2d 715 (Ct. Cl. 1979), and *Pacific Far East Line, Inc.* v. *United States*, 544 F.2d 478 (Ct. Cl. 1976), decisions that petitioner did not cite in either court below. *Pacific Far East Line* and *Oglebay Norton* involved the question of eligibility for the investment tax credit of ships paid for with funds from certain tax-deferred reserves established under the Merchant Marine Act, 46 U.S.C. 1177 *et seq.* In *Pacific Far East Line*, the taxpayer had paid for part of the cost of two ships with such tax-deferred funds. By statute, the taxpayer was not permitted to include that part of its purchase price in its "basis" for purposes of depreciating the ships. The Court of Claims rejected the government's argument that only that portion of the ships' cost that was depreciable was eligible for the investment tax credit, concluding that the entire cost of the ships qualified for the credit "irrespective of the source of the funds invested" (544 F.2d at 484). In *Oglebay Norton*, the taxpayer had paid for the entire cost of refurbishing three ships with tax-deferred funds. Relying on *Pacific Far East Line*, the Court of Claims held that the entire cost was eligible for the investment tax credit, even though no depreciation was actually allowable (610 F.2d at 724-727).

There is no conflict between those two decisions and this one. In both of th se cases it was clear that the property involved was, *by its nature*, "property with respect to which depreciation * * * is allowable" within the meaning of Section 48(a)(1). It was only the source of funds used to pay for the property that, in the government's view, rendered it partially or wholly ineligible for depreciation. Here, by contrast, there is no doubt that the recoverable cushion gas, by its nature, is not depreciable property, since it is not subject to exhaustion, wear and tear, or obsolescence. *Pacific Far East Line* and *Oglebay Norton* are thus irrelevant here, and the decision below is not in conflict with them.

There is likewise no merit to petitioner's assertion (Pet. 16-19) that the decision below conflicts with *Hawaiian Independent Refinery*. The issue there involved interpretation of former Section 50 of the Code, the provision that reinstated the investment tax credit in 1971 after it had been terminated in 1969. See 26 U.S.C. (1976 ed.) 50. Under that provision, in the case of property whose construction began before April 1, 1971, only that portion of the basis attributable to construction after August 15, 1971, was eligible for the investment tax credit (26 U.S.C. (1976 ed.) 50(b)). On the other hand, if the taxpayer began construction on or after April 1, 1971, the full cost of the property qualified for the credit (26 U.S.C. (1976 ed.) 50(a)(1)(B)).

The taxpayer in *Hawaiian Independent Refinery* began construction of an oil refinery complex, consisting of a refinery and two offsite components (a tanker-mooring facility and refined products pipelines) in January 1971. The taxpayer argued that the two offsite components should be considered separately from the refinery, and that they were therefore fully eligible for the credit, because construction on them did not begin until after April 1, 1971. The court rejected this argument, concluding that the two

offsite components, in conjunction with the refinery, functionally formed a single property for purposes of Section 50, since the refinery complex was conceived, designed, and constructed as a unit (697 F.2d at 1069). Accordingly, the court concluded that, for purposes of Section 50(b), the refinery complex constituted a single property, the construction of which began in January 1971.

Petitioner's assertion that the court in *Hawaiian Independent Refinery* "held that the 'Section 38 property' is the entirety of a functionally coherent facility, not its individual component parts" (Pet. 19) is plainly wrong. The issue there concerned the determination of what constituted "a single property for purposes of section 50" (697 F.2d at 1069). Resolution of that issue depended, in part, on the congressional intent behind the peculiar transitional rules of Section 50 for property constructed by the taxpayer (*id.* at 1069 n.13). The *Hawaiian Independent Refinery* decision thus has no bearing on the question whether recoverable cushion gas should be considered separately from nonrecoverable cushion gas (and from the entire storage facility) for purposes of determining whether it is "property with respect to which depreciation * * * is allowable" within the meaning of Section 48(a)(1).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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